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CONTENTS

Page

List of Participants III

Statement of P. Royal Shipp, moderator, Senior Specialist in Social Legislation, Congressional Research Service, Library of Congress 1

Statement of Gilbert Gude, Director, Congressional Research Service, Library of Congress 3

I. Features of Nonfederal Retirement Programs, Report of the U.S. General Accounting Office, presented by Clifford I. Gould, Assistant to the Comptroller General for Federal Retirement Matters, U.S. General Accounting Office 6

II. How the Following Affect a Defined Benefit, a Defined Contribution, and a Combination Plan:

A. Benefit Formulas, presented by Harper L. Garrett, Jr., Vice President and Director of Professional Services, Alexander & Alexander, Inc 19

B. Retirement Ages, presented by William C. Greenough, Retired Chairman, Teachers Insurance and Annuity Association/College Retirement Equities Fund 34

C. Death and Disability Benefits, presented by Robert W. Kalman, Associate, William M. Mercer-Meidinger, Inc 46

D. Cost-of-Living Adjustments, presented by Dale B. Grant, Senior Vice President and Actuary, Martin E. Segal Co 60

APPENDIX

Features of Nonfederal Retirement Programs, Report of the U.S. General Accounting Office, by Clifford I. Gould 73

Benefit Formulas, paper by Harper L. Garrett, Jr 113

Retirement Age and Proposed New Civil Service Retirement Program, paper by William C. Greenough 138

Some Factors To Consider in Designing Employer-Sponsored Death and Disability Benefits, paper by Robert W. Kalman 149

Cost-of-Living Adjustments, paper by Dale B. Grant 169

The Impact of Vesting in Connection With a Retirement Program for New Federal Hires and Employee Contributions in Connection With a Retirement Program for New Federal Hires, papers by Eugene M. Kalwarski, Milliman and Robertson, Inc 179

Statement of H. Gray Hutchison, Hutchison and Associates, Inc 192

Statement of James R. Storey, Chambers Associates, Inc 196

Letter from James M. McGrath, The Prudential Asset Management Co., Inc 200

PROGRAM OPTIONS

STATEMENT OF P. ROYAL SHIPP, MODERATOR, SENIOR SPECIALIST IN SOCIAL LEGISLATION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

(The Forum met at 9:40 a.m., Tuesday, July 10, 1984, in room SD-106, Dirksen Senate Office Building.)

Mr. SHIPP. Can I have your attention, please? My name is Royal Shipp. I am with the Congressional Research Service. Jamie has asked me to be the moderator of this discussion today.

First, I would like to ask the people who are sitting in the back and standing on the sides to move to the front tables. The tables are not reserved for anyone. It makes for a cozier situation and discussion.

For those of you who don't know, there is coffee and danish in the back. Also, back on the table are papers from some of the panelists and the GAO report. You all have received the agenda of the proceedings today. GAO will go first, and we think that presentation will take about an hour, including questions. Subsequent speakers will give 15- to 20-minute presentations, to be followed by question and answer periods. Each of those discussions should last about 45 minutes. We will break for lunch for an hour, somewhere around 12 noon, whenever there is an appropriate break.

After the presentations, if you have a question, please identify yourself and your organization. Finally, don't be dismayed if you haven't received copies of the proceedings from previous forums. They haven't been printed yet, but they will be, and will be sent to you.

One of my tasks today is to introduce my boss, Mr. Gilbert Gude who is Director of the Congressional Research Service. He will introduce this final forum.

Mr. Gude has been the Director of CRS since 1977. He was a Member of the U.S. House of Representatives representing the Eighth District of Maryland from 1967 to 1977 where he served on the Select Committee on Aging, the Committee on the District of Columbia, and Subcommittee on Conservation, Energy and Natural Resources of the Governmental Operations Committee in the House. He was cochairman of the Environmental Study Conference.

Previous to serving in the U.S. Congress, he served in the Legislature of the State of Maryland from 1953 through 1966. He is active in numerous professional organizations, in public administration, international affairs, education and environmental matters. He is a member of the National Academy of Public Administration; is chairman of the Parliamentary Librarian Section—a

Parliamentary Library, I gather, is like the Library of Congress, and every country has one; International Federation of Library Association; vice chairman of the Board of Trustees for the Catholic University of America; and is executive director of the Potomac River Basin Consortium.

I am very pleased to introduce Mr. Gilbert Gude.

STATEMENT OF GILBERT GUDE, DIRECTOR, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Mr. GUDE. Thank you so much, Royal. Royal Shipp is a senior specialist in social legislation in the Congressional Research Service. Royal's leadership and work in the retirement and Social Security programs area has been outstanding.

I appreciate the opportunity to be here. The Congressional Research Service has already played, and is going to continue to play, a major role in the development of a new Civil Service retirement plan. Our work actually began 3 years ago when, at the request of Senator Stevens, we examined options to establish a new Federal retirement program. The Service submitted its report to Senator Stevens in December 1981 entitled "Restructuring the Civil Service Retirement System: Analysis of Options to Control Costs and Maintain Retirement Income Security." It was issued as a committee print in January 1982.

Since that time, the Service has contracted with the Hay Associates to assist in developing a computer model which can be used to design a new Federal retirement program.

CRS currently is working with the House Post Office and Civil Service Committee and this committee in designing such a program. We have come to recognize that such an effort could conceivably affect many factors external to the technical design of a new retirement plan. For instance, this plan could influence the design of numerous private and public plans; private investment of portions of the new fund could have serious implications for the economy. The cost of the plan will impact the Federal budget in its size and its direction.

The ultimate decision for a new plan, of course, is not in the hands of the Congressional Research Service, but we are striving to refine our tools to best answer how certain decisions about the new plan will affect various other factors.

These forums have played a critical role in the process to develop a well thought out and equitable retirement program for the Federal Government.

The process, to no one's amazement, is inevitably going to become highly political as bills are introduced and considered, but I believe that the foundation work accomplished at these forums will put the forthcoming political debate on a far higher plane. That is, after all, what the Congressional Research Service and its fellow agencies that are involved in this project--the General Accounting Office and the Congressional Budget Office—are about, endeavoring to shed more light and less heat on very controversial subjects.

Also, these forums have helped us at CRS to better understand the issues that need to be considered so we can be prepared to assist the Congress when the issues arise.

To this end, we in CRS look forward not only to developing the comprehensive reports but also to providing clear summaries of the issues that are involved through summary reports and issue briefs which can be utilized by the membership of the full committees as well as all of the Members of the House and Senate.

I want to thank Jamie Cowen and Ed Jayne who are in charge of the committee staffs on both sides for their leadership, their interest, and the close working relationship that they have helped us evolve in the course of these various deliberations. On behalf of Senator Stevens, Senator Bingaman and all the other members of the committee, I want to thank you for your participation today.

Mr. SHIPP. Thank you, Mr. Gude. This is the fifth of these educational policy forums. Many of you have been to all of them, I expect. The first one dealt with basic economic security programs, with particular emphasis on retirement income programs. The second dealt with pension design issues; the third explicitly with integration of the pension system with Social Security; and the fourth with funding and investment issues. The fifth and final forum will consider "Program Options." Throughout the series, the topics have gone from general to specific issues. Program Options is the most specific of the five.

When the series began, letters of invitation, press releases, and other material announcing the five forums emphasized the educational, bipartisan nature of these programs. The purpose of the forums has been to assist the Congress in determining what type of retirement income program should be provided to new Federal workers covered by Social Security. The forums were designed to educate and to clarify issues, not just for participants in the forum but for others who have to deal with the issue. The forum sponsors intended them to be preparatory to congressional hearings and subsequent congressional analysis of the specific program options.

Leading off the policy forum today on program options will be Cliff Gould from the General Accounting Office. He will present a report on the work of the General Accounting Office in identifying prevailing non-Federal pension practices.

Cliff Gould was recently designated Assistant to the Comptroller General for Federal Retirement Matters. Immediately preceding this assignment, he was Director of the Federal Personnel and Compensation Division. Mr. Gould began his career with the General Accounting Office in 1954 as a GS-5 trainee and served in progressively more responsible positions in the Kansas City Regional Office until 1965. He served as Assistant Director of the Far East Branch from 1965 until 1971, and as Assistant Regional Manager in charge of the St. Louis suboffice during 1971 and 1972. He was designated Associate Director in the Federal Personnel and Compensation Division in March of 1972 and Deputy Director in 1976. During 1980, he served as Special Assistant to the Comptroller General responsible for directing the implementation of the requirements of the GAO personnel legislation.

Mr. Gould has received a variety of awards from GAO, including the Meritorious Service Award in 1958; an Outstanding Performance Award in 1967; a Career Development Award in 1969; and Distinguished Service Award in 1977. He is past chapter president of the Association of Government Accountants and a member of the Federal Executive Alumni Association; the International Personnel Management Association; and the American Society for Public Administration.

I am very pleased to present Mr. Clifford Gould.

I. FEATURES OF NONFEDERAL RETIREMENT PROGRAMS, REPORT OF THE U.S. GENERAL ACCOUNTING OFFICE

(Presented by Clifford I. Gould, Assistant to the Comptroller General for Federal Retirement Matters, U.S. General Accounting Office)

Mr. GOULD. About a year ago, the chairmen and ranking minority members of the Committee on Governmental Affairs and of the Subcommittee on Civil Service, Post Office, and General Services, requested assistance from the General Accounting Office in the design of a new retirement system for Federal employees who are hired after January 1 of this year. We were asked to collect and analyze information on prevailing retirement features in the non-Federal sector, both the public sector and private sector. The committee wanted to use this information in designing a new supplemental system for new Federal employees.

One of our first concerns was with the definition of the private sector. Obviously, you can't look at everybody in the private sector. There are all kinds of plans and features out there. We reached agreement with the committee that we would use a report put out by the Bureau of Labor Statistics entitled "Employee Benefits in Medium and Large Firms" and the data bases supporting this report.

This report is based on BLS' analysis of retirement and other benefit programs in the private sector establishments used in the Federal pay comparability process for salaried employees. Therefore, it is not necessarily representative of the entire private sector.

The 1982 report, the last one completed at the time of our review, covered a survey universe of 21 million employees, of whom an estimated 84 percent, or 17 million employees, participated in pension plans. A total of 976 pension plans were included in the BLS survey. The BLS survey universe included establishments employing as few as 50, 100, or 250 full-time employees, depending on the industry surveyed.

In accomplishing our objectives, we also wanted to look at other data and other published studies to see if there were consistencies with the BLS survey. The BLS information is presented as percentages of employees. Most of the studies by other companies deal with percentages of plans. If there were any inconsistencies between any of the studies, we tried to discern the reasons for them.

We relied on other studies—Bankers Trust Co., "Corporate Pension Plan Study—A Guide for the 1980's." This study includes 325 retirement plans and 240 companies. This is a 1980 study, but has been cited by others and we felt it was important to include in our analyses to see if it was consistent with the other studies.

Hay Associates, "1983 Hay-Huggins Noncash Compensation Comparison," which is a study of 781 private sector plans.

Hewitt Associates, "Salaried Employee Benefits Provided by Major U.S. Employers in 1982." This study covered 678 private sector retirement plans.

Wyatt Co., "A Survey of Retirement, Thrift and Profit-Sharing Plans Covering Salaried Employees of 50 Large U.S. Industrial Companies as of January 1, 1983." This is a relatively small universe, but we also wanted to see if it made any real major differences in whether you took a large sample or small sample.

For the State plans, the National Association of State Retirement Plan Administrators, September 30, 1982, study, "Survey of State Retirement Systems," includes information on all the State pension plans. We used the survey information from that study for general employees, but did not use the survey data on special categories of employees, such as police, firefighters, and teachers. Since all the studies didn't identify the survey participants, we cannot determine the extent of duplication in participant coverage that might exist. We do know there is some, so the study is biased to the extent that there are some companies included in several of the surveys.

Each of the studies did not always include data on the retirement program provisions as discussed in our report, but where possible, we supplemented that data with information contained in other more limited studies.

The studies in our report focused primarily on retirement programs for salaried employees since we felt those were the employees being considered for the supplemental plan.

What we will present here is a series of slides, which are also in the report, taking each of the individual provisions to show the prevailing practice, I won't say for the entire private sector, but certainly for the plans that were covered by these studies.

The first of the features is the vesting provision. We found that there was a prevailing practice of 10-year vesting of benefits. That really didn't surprise us too much because that is the ERISA requirement and most of the companies have moved to 10-year vesting.

We found most of the plans are integrated with Social Security in some manner. State plans are an exception to this. Social Security came along after most of the States had established their plans, so they simply added Social Security to the existing plans and did not go back and try to integrate the plans. There has been previous discussion on how to integrate, and we found the prevailing practice there does seem to be to use the offset. A typical offset is about 1¼ percent of the Social Security benefit multiplied by years of service.

We found most employees are not required to contribute for the pension portion of their retirement program. I want to emphasize "pension portion" because employees in the private sector and State and local governments do contribute to Social Security and, in many cases, they also contribute to some sort of capital accumulation plan. But for the pension portion alone, the employees generally do not contribute.

We found that final average salary is used, as opposed to career average salary, in almost all the plans. There doesn't seem to be any argument that that is the method used to determine the benefits that are granted.

There has been a lot of discussion on whether that ought to be 3 years or 5 years. The Wyatt study showed about half of the companies use a 3-year average. The States also use a 3-year average. In the States, we believe that is because they followed the Federal lead.

In the Wyatt study, about half of the companies in the 50-company survey are oil and chemical companies which have traditionally used the 3-year average as opposed to a 5-year average. When you put those into a larger universe, the percentages drop drastically so that 3 years does not seem to be the prevailing practice, but 5 years is above the 50-percent category in most of the studies. We would have to conclude 5 years is probably the prevailing practice of the private sector.

We found that the age for unreduced benefits is age 62, or earlier. That, again, in some of the studies is just slightly over 50 percent. The Wyatt study, again, with the small universe, does go up substantially above that.

We also found that making benefits available by age 55 does seem to be the prevailing practice. That is not unreduced, however. There is a reduction requirement for retirement at age 55 in most of these plans. The question of how much of a reduction is really one I think has been debated here before as to whether it should be a percentage reduction or actuarial reduction. We have found that for reductions below 62, the average is about 5 percent a year. Bob Myers might say that is actuarial. I am not sure it is or not. Most have some sort of percentage, and they vary a lot. Some require a large percentage in the earlier years from 65 to 62, and then a smaller reduction below that; some are just the opposite. We have some additional work ongoing now to try to get a better handle on that for the committee.

There have been a lot of discussions about COLA adjustments. We prefer not to call them COLA's. They are post-retirement adjustments. We found that most of the companies in recent years have granted some sort of a post-retirement adjustment to the retirement benefits for their employees. These also vary all over the lot.

We were fortunate to find a recent study that was done by the Department of Labor. They commissioned a study by North Carolina State University, and overall, they found the retirees from the private sector who were receiving staff pensions in 1972 received post-retirement adjustments during the period 1973 to 1979. About 75 percent of those retirees received at least one adjustment.

This is one of the cases where size of companies seemed to make the difference. The percentage of post-retirement increase granted by small plans of a hundred or less recipients was about 5.5 percent of the CPI increase during that period of time, 1973 to 1979. In large plans of 10,000 or more recipients, that was about 57 percent of the CPI increase during that period. Overall, the DOL study indicated the average retiree received increases equivalent to about 38 percent of the Consumer Price Index increase.

We also found that in addition to regular pension plans, there are frequently capital accumulation plans. Four of the studies we had indicated that in addition to the pension plan, there was some sort of capital accumulation plan, either thrift plan, profit-sharing, PAYSOPS, 401(k)'s. Those kinds of plans are where the employee participates and the company provides some sort of a match. The general trend seems to be for the employee to contribute up to 6 percent of pay and about half of that would be matched by the company.

We have also found that these are becoming a very large feature in the private sector, particularly in terms of 401(k) aspects. It is our observation that capital accumulation plans may provide more benefits than some of the pension programs as they have a chance to accumulate more into those funds.

Typically, we found the private sector provides a pension plan, Social Security and some sort of capital accumulation.

I don't have slides on a couple of other features I did want to mention. The BLS study found, and some of the other studies found, that most private sector salary-based pension plans used long-term disability insurance rather than providing disability retirement benefits under the pension plan. Long-term disability insurance plans usually paid 60 percent or more of pay. These payments were offset in most cases by other disability payments that the employee received from programs such as Social Security and Workers' Compensation.

When the long-term disability insurance approach was used, most plans paid deferred retirement benefits with service credits allowed during the deferral period. Only five States used the disability insurance for long-term disability. The other States provided disability benefits under the pension plan.

As it relates to survivor benefits, most private sector pension plans required employees to be eligible for early retirement before survivor benefits were payable upon their death. They tended to rely on life insurance and Social Security to provide survivor benefits to younger employees. We could not discern any prevailing practice on preretirement survivor eligibility in State plans. Eligibility requirements ranged from immediate coverage to eligibility for early retirement.

Nearly all the private sector plans required actuarial reductions when survivor benefits were elected.

I will be happy to take any questions related to the presentation and report. I am sorry you didn't get the report earlier. Under the ground rules, the Senate Committee controls release of GAO studies done at their request, and they wanted to release it at the policy forum today.

I know you haven't had a chance to look at it. If you have any questions now or future questions, feel free to give us a call. They told me I had an hour this morning. They told me the other day I had 15 minutes. I went through it perhaps a little more hurriedly than I might have preferred.

Before I quit, I do want to commend the committee, Jamie and Ed for their efforts in putting the policy forum together. I think it is a tremendous task they have undertaken. I hope that it results in a successful program that is fair to the taxpayer and fair to the Federal employee.

Mr. SHIPP. We will now have questions. It may be best, Cliff, for you to sit and answer questions from your seat. Thank you very much, Cliff.

Mr. GARDNER. Larry Gardner, personnel director, Farmers Home Administration.

The study indicated that most companies had defined benefit plans. What was unclear to me in reading the material, at least quickly, was whether that defined benefit varied over the life of the plan. For example, were you able to find cases where there was a defined benefit that then changed during the employee's coverage under that plan? Did you get any feel for that in the studies?

Mr. GOULD. I have my staff here, too. They are free to enter into the discussion in case I misstate anything. What we found was that generally most of the companies in these studies have both a defined benefit and a defined contribution plan. You have both kinds of plans. To my knowledge, we didn't discern any change in the coverage of those plans during the period of the employee. Am I wrong, Tom?

Mr. EICKMEYER. Tom Eickmeyer with the General Accounting Office.

The plans we looked at and the statistics in the report are at one point in time. Many of these plans have had modifications over a period of time. We didn't see any trends or any numbers of plans being switched between a defined contribution to defined benefit type of plan.

There are some instances; some of the States have switched their plans from one to the other. There was no discernable trend in that area.

Mr. GARDNER. Perhaps I didn't ask the question properly. When there was a defined benefit plan and employees were covered under that plan, if there was a later adjustment to that plan—for example, adjustment in terms of at what age the employees could retire—No. 1, did you find examples of that, and, if you did, how was that handled in terms of, for example, grandfathering of those people covered under the defined benefit plan?

Mr. EICKMEYER. Most of the changes that we discerned in our study—and also we visited several of the large companies around the country—the plans were generally liberalized and the more liberal provisions were applied to everybody.

In several of these cases, especially in cases of mergers of large corporations where they picked up other organizations, they would liberalize their plans picking up the provisions of the other programs so that one plan might cover all of the employees, all of it being more liberal than the prior plans.

In the case of benefits, it seemed what we had learned was that often the benefits accrued under the earlier plans prevailed throughout. They didn't pick up the more liberal benefits for the earlier periods of time. Other kinds of changes applied retroactively to everybody.

Mr. GARDNER. Thank you.

Mr. SHIPP. Other questions, Jim?

Mr. STOREY. Jim Storey, Chambers Associates.

Cliff, I was wondering if you have any data on the prevailing service requirement for age 55 retirement? You show that age 55 was a common age for early retirement to be allowed, but you didn't mention what the requirements are for eligibility at age 55.

Mr. GOULD. I don't have the chart here. Prevailing practice seems to be 10 years of service at age 55. Once you are vested, you can go at age 55, but you will take a reduction in benefits if you take that early retirement.

Mr. SHIPP. Question in the back.

Mr. CASTELLS. Manuel Castells, Kwasha Lipton.

In the area of private plans, I notice that integration with Social Security was overwhelmingly the case. In the State plans, however, it was fairly low. Our general feeling in the private area is that the lack of direct integration is usually reflective of some degree of implicit integration.

Did you find any relationship between benefit levels in the States that participate in Social Security and are integrated versus the ones that don't have any integration and who participate in Social Security?

Mr. GOULD. What we generally found is the States had a plan in effect when they became covered with Social Security and they simply added Social Security to that. They did not adjust the benefit levels.

In contrast with that, most of the private sector firms had Social Security first and had an opportunity to design a system that supplemented the Social Security. I think as a general answer to that question, I don't think there was any general relationship to the benefit levels. I think it was just done for simplicity purposes.

Mr. SHIPP. Other questions.

Mr. GALLEHER. Rick Galleher representing FAIR.

We found very significant that 93 percent of the workers in the private sector do not have to make any contributions to the retirement system. Also interesting in your study was the information that State employees in fact generally do make contributions. I wanted to ask about the trend you noted in your study on the pickup of employee contributions.

Under 482, Internal Revenue Service Code, where the employee could effectively provide all contributions at the State level to be tax deferred, would that have the applicability in the Federal sector? Could you comment on that?

Mr. GOULD. I would like to think it does, but our attorneys tell us that would require legislation. We have talked with the people at Treasury. They feel that needs to be handled through legislation with the Ways and Means Committee. But some of the States under that provision can pick up the employee contribution and make them free-tax. Some of the States we learned are doing that at the present time. As of now, the way the law is written you could not do that in the Federal Government.

Mr. GALLEHER. You indicated this is rather a trend, 15, 16 States apparently considering it.

Mr. GOULD. That's correct.

Mr. GALLEHER. If I understand your presentation effectively, taking the average taxpayer, you might effectively lower the contribution of the employee on an after-tax basis by about one-third.

Mr. GOULD. That is probably pretty close. The employee's take-home pay is going to go up, but the contribution is going to remain the same.

Mr. GALLEHER. Is the GAO considering any follow-up research on the later reports as to what type of language would be necessary to extend this same privilege and right to Federal-sector workers that exist now for State workers?

Mr. GOULD. We have that under active consideration. We discussed that with the committee staff. We think they are receptive to it and think there is a chance they will do something with it in this regard in the legislation.

Mr. GALLEHER. Will it be, as I understand, in addition to any type of thrift plan——

Mr. GOULD [interposing]. That is correct. That would be a 401(k) approach, probably.

Mr. SHIPP. Bob.

Mr. MYERS. Bob Myers, consulting actuary. I think that one of your charts could present a little misleading picture, although if you look at the full report, the matter would be cleared up. Your chart on page V shows that roughly 60 percent of private plans allow unreduced benefits at age 62 or earlier, as against about 80 percent for State plans. But if that chart were on the basis of not "age 62 or earlier," but rather "before age 62," you would have gotten an entirely different picture, as you can see from your table on page 11.

Most of the private plans that allow retirement at age 62 or earlier actually allow it just at age 62. In other words, around 35 percent of the private plans allow unreduced benefits at age 62, meaning only about 25 percent allow unreduced benefits before age 62.

What you have in your text is quite correct. What your chart shows is quite correct, but it does imply something that I think is not really there.

Mr. GOULD. I think your observation is correct, Bob. That chart does include retirement at age 62. It also includes retirement, unreduced retirement at age 55 and also includes unreduced retirement at any age.

We have a problem in how to present that graphically. If you only showed the 62, you wouldn't pick up those that are eligible to go before age 62. It was a tradeoff of how it was presented.

Since the entire factual information is in the report, we don't think it is misleading.

Mr. GALLEHER. A followup question on the same chart. Does the chart exclude hazardous-duty employees, those employees who——

Mr. GOULD [interposing]. It only includes general employees.

Mr. GALLEHER. To that extent, the table might be biased upwards slightly compared with a complete sample of the private sector.

Mr. GOULD. If you include fire and police, there would be more people who are eligible before age 62.

Mr. SHIPP. Jamie.

Mr. COWEN. Jamie Cowen, with Senator Stevens. Did you find any evidence of the range of employees utilizing the capital accumulation plans? Was there a tendency toward only the high income and middle income, or was it across all salary ranges?

Mr. GOULD. We didn't discern any difference between high- and low-grade employees. As you know, the law requires nondiscrimination in these provisions. The upper one-third cannot contribute significantly more than the lower two-thirds. IRS monitors those pretty closely to make sure no discrimination takes place.

Mr. KEITH. Hastings Keith with the National Committee on Public Employee Pension Systems. One of the features of the Federal plan is we credit the military service very extensively, and I wonder if any State plans do that and if any of the private sector plans—I understand they cost several billions of dollars just for crediting military service in the Federal plan. Can you comment on that?

Mr. GOULD. I don't know that we found anything one way or the other on that, Hastings. We did find the companies do allow credit for service during employment with their company. If you consider military service as service with the Government, then there seems to be no reason to exclude that. If you come to the conclusion that that is not Government service, it is some sort of other service, then you would have a legitimate reason for excluding it.

As far as these studies are concerned, we did not find one way or the other.

Mr. KEITH. I understand the need of the national policy to encourage people to participate in reserve and guard activities, but I am talking about a man who has 5, 10, 15 years with military service and goes into the Civil Service and that counts toward his retirement plan, even if it is only 2 or 3 years. It is a very important factor in determining the age and amount of service that is required as well as the total benefit, and it costs in the billions of dollars. I doubt that any private sector plan, except perhaps public utilities, would give credit for past military service, not of a reserve status but just the 2 or 3 years of wartime service or 5 or 10 in the post office department, it is very expensive.

Mr. SHIPP. Several people want to comment on that.

Mr. EICKMEYER. If I could amplify on Mr. Gould's answer, we did not find any information on cases where service credit was granted for military service prior to employment with the company or with the State. However, there were several instances where the company would grant service credit for the military service time if it occurred after the person became employed by the company, where the employment with the company was interrupted by the military service; the company granted service credit for that, but there was very little data on that available in the studies.

Mr. GEORGE GOULD. George Gould with the National Association of Letter Carriers—sounds redundant. Under present law, is the National Guard and Reserve service counted toward retirement?

Mr. GOULD. I am going to have to defer to my experts here. I do not believe it does. I think only active-duty service counts toward Civil Service.

Mr. SHIPP. They are nodding their heads in agreement.

Mr. KEITH. May I ask one further question?

Mr. SHIPP. Hastings Keith.

Mr. KEITH. The TVA does not count military service in the same way the Federal Government does. They have the same observance of national policy, but it is estimated it saves 2 or 3 percent of payroll.

Mr. **Gould**. Which retirement program are you talking about at TVA? They have several and some do give military service credit.

Mr. **Keith**. I was unaware any of them give military service credit except as reservists or guards. Certainly the fact was brought to our attention by the TVA and they took pride in the fact they saw no reason why someone with 2 or 3 years of military service should retire any earlier or get any more of a pension than one who started without that service.

Mr. **Galleher**. I would like to look closely, if we could, at page 11 of your report on early retirement. I would like to ask some questions following up on the requirement for service levels for early retirement. The chart at the bottom of page 11 indicates that at age 55 in the private sector, between 90 and 95 percent of all the pension systems, whether they are studied by BLS, Bankers Trust, Wyatt or State plans, allowed employees to retire either on a reduced or unreduced basis.

I was wondering if your research found any statistics on the number of years of service required to retire on an unreduced basis versus the number of years in service required to retire on a reduced basis and what the numbers would be?

Mr. **Gould**. I am not sure we had any definitive answer to that. We did find a number of companies who do not apply the reduction at age 55 if you have 30 or more years of service. I would not say that is a prevailing practice. There is not enough information to really give you a good handle as to whether that is prevailing. My guess is it would not be.

Mr. **Galleher**. On the other hand, those companies who do allow retirement at age 55 on an unreduced basis, would their service requirement be greater or less?

Mr. **Gould**. Did you say unreduced?

Mr. **Galleher**. On a reduced basis, 10 years.

Mr. **Gould**. On a reduced basis generally the vesting requirement is the only requirement to take a reduced annuity. On an unreduced basis, generally if you didn't have 30 years, you would have to take a reduction of some sort.

Mr. **Galleher**. For those retirement plans that do allow age 55 retirement on a reduced basis, they would be required just to have the vesting for 10 years?

Mr. **Gould**. That is correct. The benefits you would accumulate in 10 years with a reduction probably would not be all that great. Most of the plan provisions do allow it. Some will allow it with no service requirement.

Mr. **Castells**. I would like to go back to the answer to Jamie's question. I believe there was a misstatement in it. I think your reference with regard to discrimination rules had to do with rules on section 401(k), and I think you stated that the top one-third can't contribute more than the bottom two-thirds. In fact, generally they can't contribute more than 150 percent of the bottom two-thirds.

Mr. **Gould**. I stand corrected.

Mr. **Myers**. Just a question along the lines of the previous discussion. When roughly 15 to 20 percent of private plans allow unreduced annuities at age 55 or earlier, what sort of service requirements do they have?

Mr. GOULD. Again, Bob, I think as a rule it was 30 years to get the unreduced annuity at age 55.

Mr. STOREY. Cliff, on your slides on integration, you showed that the plans in the BLS sample had a lower rate of integration with Social Security than those in the other private sector samples. Since BLS is showing data as a percent of employees participating rather than of plans, is it correct to infer that larger plans are less likely to be integrated and that that is why integration was lowest in the BLS survey?

Mr. GOULD. I think I am going to have to defer to staff on that one, Jim. I am a bit fuzzy. In one instance, I think we used the overall figures on BLS. Is this the one, Tom?

Mr. EICKMEYER. Yes, the BLS survey had a lot of dollar amount formula plans or blue-collar plans as compared to the other studies which generally had compensation-based formulas. The blue-collar plans are generally less likely to be integrated with Social Security, and because probably one-third of their study included these kinds of workers, their numbers, their percentages of integration were lower than other studies.

Mr. GOULD. Jim, I might add, we weren't concerned with precision here as much as general trends. Too much of the past discussion has been "my survey shows this percent," "my survey shows this one," and so on. We get into too many arguments as to whose data is correct.

What we hope to do with this study is show general percentages without the kind of precision we normally talk about.

Mr. GALLEHER. Is it also possible to say the integration relationship is related with whether or not the workers are unionized? Does the BLS data verify that? It is my understanding that generally unionized plans, even if they are not production workers, tend not to be integrated in comparison to nonunionized workers. Did the BLS study show that?

Mr. EICKMEYER. We did not analyze specifically for the union versus nonunion, but I would think that the data would probably bear that out. The benefits of blue-collar workers who are in the dollar-amount formula plan generally would not be integrated.

Mr. SHIPP. Jamie.

Mr. COWEN. Cliff, I have a question about retirement age. It seems to me an employer's goal is to provide a replacement rate objective, which includes Social Security. In other words, Social Security takes care of a substantial portion of the overall benefit that is granted the employee. If an individual is eligible to retire under age 62, then isn't it true that not only is that person subject to a direct penalty of 2, 3, 4 percent per year, but also in a sense a penalty because they are not receiving Social Security benefits which take care of a substantial portion of their retirement benefit?

Mr. GOULD. Again, Jamie, the data is not all that clear. There are a number of companies that provide some sort of benefit leveling option where you take a larger percentage of their pension early and take less pension later on so that it equals what you would get overall.

Some of the plans do not provide for any offset in the Social Security until age 62, so there are all kinds of provisions for companies that have taken the approach that they don't want their employees to suffer any sort of reduction.

One of the things we did not include in the slide presentation is a practice shown in a couple of studies; that is, no service credits after age 65. They seem to want to try to keep people until age 62 and thereabouts, but not to keep them much beyond that.

Mr. **Young**. Harvey Young, Metropolitan Insurance Co. I think you have to keep in mind that retiring at age 62, even with unreduced benefits, is on a voluntary basis. It is not as if the employers are forcing the employees out. The presence of benefits after age 62 makes it a matter of choice and is a major consideration in the decision.

Mr. **Losk**. Norm Losk, representing the American Academy of Actuaries. The data you have here seems to show a snapshot of the state of the art in the pension scene as of a recent date. I wonder if your data indicates whether or not there have been changes in practices in integration with Social Security over recent years? Specifically, are there moves toward offset integration or away from offset integration?

Mr. **Gould**. We really can't tell from the data. That would really take a separate study in itself to look at trends. As I indicated before, we did not go out and do a survey on our own. We tried to use the available published information to see if it was consistent with each other at least in a general sense.

Mr. **Gardner**. Most of the studies seem to concentrate on voluntary retirement. Did you find in your survey any ground rules with private industry companies when the employee was involuntarily released through job abolishment, or that sort of action? Were there reduced or unreduced retirement provisions connected to that kind of involuntary separation?

Mr. **Gould**. I don't believe there was anything in the survey data we looked at that would show one way or the other. We are aware those things generally are not set down in the plans themselves. The company decides what they are going to do in terms of providing some sort of an early retirement option. I would guess a lot of that depends on the financial position of the company as well as the concern for the employee. We didn't as a general rule find anything in the plan provision itself that would lead you to conclude it was provided for up front.

Mr. **Shanefelter**. Al Shanefelter, General Accounting Office. To clarify what Cliff was saying, we visited several major corporations and many of the negotiated settlements contained a provision whereby by about age 45, you would go out with a retirement benefit with a minimum reduction in the case of a plant closing. U.S. Steel is a good example.

Mr. **Galleher**. Was there any relationship between the size of the plans and the number of participants and the early retirement provisions both on an unreduced basis and on a reduced basis? That is to say, perhaps the larger retirement plans provide more liberal benefits in these areas?

Mr. **Gould**. We don't have a breakdown to provide that kind of information. It would be useful to have. The only thing we do know is the numbers in these studies do include firms of all sizes. My guess is the larger companies probably would be more liberal in that, but I can't say that with certainty.

Mr. GALLEHER. The BLS survey and procedures, I know, vary from cutoff size of 50 in a firm to a cutoff size to 250. Would it be possible with that BLS data to run checks on it, perhaps using a cutoff of 250 and larger and run a table showing that information for comparison purposes because I suspect larger firms, perhaps, would have a lot more liberal provisions than we would see in these overall tabulations?

Mr. GOULD. Tom, is that data base stratified so you could do that? Working with that data base is tough to deal with. I am not sure it is stratified to do that.

Mr. GALLEHER. If it was based as it was designed for the pay comparability survey, then I do believe there are ways you can rework the raw data and use different cutoffs for the industrial firms. And if so, I do believe the results of that provision would provide a very significant amount of information on the trend of the differences between the retirement benefits for smaller firms and larger firms.

Mr. SHIPP. We are going to take one more question on this, unless somebody really—OK, we are going to take two more questions. Ed Jayne and then Ray Schmitt.

Mr. JAYNE. Ed Jayne, with Senator Bingaman. In the report you mentioned you are doing a follow-up report for us on the level of benefits. I just wondered if you could elaborate a little bit on the methodology of that report and what we expect from that phase of the second report?

Mr. GOULD. We are doing a couple things for you. One is we are going to try to take a look at the amount of reduction provided for early retirement at age 55. As I recall the overall trend, the reduction from 62 to 55 is about 35 percent. We want to try to get a handle on where those reductions take place. It appears there is a big reduction between 60 and 59, but that is based on a limited amount of information at this time.

The other thing we are going to try to do is take a look at some of the replacement rates. Hay Co. has a study that does that for a lot of companies, and we are working with them to try to get additional information for the 55-year retiree. We are also trying to do some of that analysis with the BLS data base so we can give you a better handle on what the total replacement rate would be when you consider the private pension, the Social Security and the thrift plans that are available.

Mr. JAYNE. So some of the follow-up information will perhaps answer some of these questions we are getting into now.

Mr. GOULD. We hope so.

Mr. SHIPP. Ray.

Mr. SCHMITT. Ray Schmitt, Congressional Research Service. I don't have a question; a bit of information. If you want to look at the retirement benefits for major corporations, the Wyatt Co. survey shows the top 50 salary-related plans and you can get a handle on what they do versus early retirement, how many years you have to have, what type of early retirement reduction would be applicable. So if you just take a look at the Wyatt survey, you will get that information.

Mr. SHIPP. Thank you very much, Cliff. Moving right along, and being currently on schedule—you have got your agenda in front of you—we are going to the second presentation. Keep in mind that we are talking about program options during this policy forum today. Of course, the background from practices in the private sector gives us guidance and guideposts on thinking about that.

It appears from our agenda there have been some certain assumptions about program options. Either the pension program will be a defined benefit, a defined contribution or a combination. I suppose that covers all bases. The question is, for our next speaker, how benefit formulas affect the choice among these major program options.

The person who is going to present this to us is Mr. Harper L. Garrett. Mr. Garrett is Vice President and Director of Professional Services for Alexander & Alexander and is also their Chief Actuary. He has overall responsibility for the standards and quality of professional services provided nationally to clients by A&A's Human Resource Management Group.

Before joining A&A in 1975, Mr. Garrett was Vice President for Group Operations at Mutual of New York, having been with them for 18 years, the majority of which time was involved in employee benefits. He is a Fellow of the Society of Actuaries; a Fellow of the Conference of Actuaries in Public Practice; a member of the American Academy of Actuaries and an Enrolled Actuary. He currently serves on the American Academy of Actuaries' Committee on Pension Actuarial Principles and Practices and also on the Academy's Pension Accounting Committee.

We are very pleased to present Mr. Harper L. Garrett.

II. HOW THE FOLLOWING AFFECT A DEFINED BENEFIT, A DEFINED CONTRIBUTION, AND A COMBINATION PLAN

A. Benefit Formulas

(Presented by Harper L. Garrett, Jr., Vice President and Director of Professional Services, Alexander & Alexander, Inc.)

Mr. GARRETT. Thank you, Mr. Shipp. Good morning. There are two basic methods of providing for retirement income, either through application of a benefit formula in a defined benefit plan, or through an accumulation of moneys in a defined contribution plan.

The most comprehensive definition of a benefit formula applies when discussing defined benefit plans and it must include specific answers to the following questions:

How much the benefit is to be; when it is to be paid; and how it is to be paid. In other words, the benefit formula will define the benefit accrual rate, the normal retirement age and the form of payment; for example, life annuity, a joint and survivor annuity, or perhaps a lump sum.

I have been asked to concentrate my remarks today primarily on that portion of this definition dealing with accrual rates. Therefore, I will be discussing various benefit formulas, with regard to the compensation base used, patterns of benefit accrual, including front-loading and back-loading, and Social Security integration formulas. I will also try to focus on how each of these affects a defined benefit plan and a defined contribution plan. I plan to cover defined benefit plans first.

Before I get to accrual rates, however, I do want to address briefly the retirement age and form of payment. In the corporate world, age 65 is almost universally the normal retirement age specified in the plan. However, an important element of the benefit formula related to the retirement age is the early retirement provision; in other words, some employers encourage early retirement by permitting employees to retire earlier than the normal retirement age with less than a full actuarial reduction in the benefit. This is known as subsidized early retirement and certainly increases the cost of the plan. In many corporate plans, and certainly in most of the very large plans, retirement at age 62 with full unreduced benefits is not uncommon, and in these situations, age 62 can generally be considered the de facto normal retirement age.

I should also note that there are a number of plans in private industry where an employee may retire with full unreduced benefits depending on combinations of service and age, for example, age 60 with 20 years of service or age 55 with 30 years of service, similar to the current Civil Service Retirement System. Deferred retirement may or may not provide for a continuation of benefit accruals and this in turn can affect the cost of the plan, although deferred retirement generally reduces the cost of the plan.

Finally, just a word on the form of payment of the benefit, that is, the way in which it will be paid. In private industry noncontributory plans the normal form is a life annuity. Most plans also offer the employee the selection of several other options such as life and 10-year certain or joint and 50-percent survivor, and so on. Each of these forms is calculated as an actuarial equivalent to the life annuity.

For example, if an employee was scheduled to receive $100 a month at age 65 as a life annuity, and instead elected to receive a 10-year certain and life thereafter annuity, the benefit would then be reduced to $91 per month. In other words, this lower dollar amount, which is effectively guaranteed for at least 10 years and then for life thereafter is actuarially equivalent to $100 a month payable for life.

A corollary to the form of payment might also be whether such payment is to be constant in amount, or will increase in amount over time to recognize cost-of-living increases. Very few private plans automatically increase payments to retirees, instead utilizing occasional ad hoc increases; but even here, rarely if ever is the full impact of cost of living recognized. The Civil Service Retirement System normal form of benefit, unlike the overwhelming majority of private plans, is indexed to the cost of living, and this has a significant cost impact.

Just as an example here, if we have a $10 monthly benefit payable at age 65, and we were to build in an automatic 5-percent cost-of-living increase, we would increase the actual cost of that benefit at age 65 by 44 percent. I don't want to spend any more time this morning on these latter two benefit determinants, but I did want to at least note their impact on the cost.

In the first policy forum, there was an excellent paper presented by Dr. Dan McGill, which goes into considerable detail on the impact on cost of both the normal retirement age and the normal form of annuity. I would refer anyone desiring more information to his paper. In addition, of course, this morning the next speaker is going to discuss the topic of retirement ages. So enough for now on these two important aspects of benefit formulas.

Although the past four policy forums have covered, in one way or another, most of the topics about which you will be hearing today, the committee staff felt it would be useful if we were to devote this final forum to addressing some of the major aspects of plan design, in order that you obtain some feel of how each of these aspects affects the amount of benefits and/or the cost of such benefits.

As consultants, one of the ways in which we seek to assist employers in pension plan design is to help them ascertain what the retirement income objective of their plan should be. In broad terms, this generally is expressed as the amount of income that is adequate to maintain the retired worker and his dependents on a standard of living reasonably consistent with that which they enjoyed during their preretirement years. This normally takes account of the combined benefits payable from the private pension plan and payable from Social Security to the individual.

If you will recall, one portion of the first policy forum dealt entirely with the topic of what is known as replacement ratios, that is, the percentage of retirement benefits, including Social Security, as compared to the preretirement income. Replacement ratios are generally less than 100 percent, for fairly obvious reasons, such as: The fact that taxes of the retired employee are less than those of an active employee; certain expenses associated with employment no longer exist; the cost of raising children has generally ceased; and mortgage payments have generally ceased.

Therefore, typical replacement ratio objectives in corporate plans range from about 50 to 60 percent for higher paid employees up to about 70 to 80 percent for lower paid employees.

In addition, I should note that these replacement ratios are generally targeted toward a full service employee, that is, one who has rendered 30 or perhaps 40 years of service with one employer.

In comparison, the Civil Service Retirement System provides the same replacement ratio for a low paid or a high paid employee if each has the same length of service.

Here I just tried to show a full-service employee of 42 years; this straight line across here shows a replacement ratio of approximately 77 percent, after averaging the high 3 years. Obviously if it were less than that, if he were to have 35 years of service, this straight line would be lower, probably somewhere in here, at about 63 percent. It is not a very good straight line.

You will note in computing replacement ratios, the individual's personal savings are generally not taken into account. Most of us need only look at our own personal cumulative savings to understand why this is so. Briefly, one's personal savings would normally not provide a very substantial amount of retirement income when converted into an annuity stream. Any personal savings may simply be thought of as a supplement to the retirement income.

I mention the replacement ratio in some detail again today only to emphasize the point that in starting to design any type of retirement plan, it is absolutely necessary to have a goal, and that goal in the private sector is generally expressed either as the benefit objective or the cost to provide benefits. Our emphasis this morning is on discussing benefit design, but let me say at the outset that whenever any one of us is discussing one benefit which is richer than another, keep in mind the obvious corollary that the richer benefit is also always costlier to fund.

Now I believe we are ready to turn our attention to accrual rates, and how they can be used to produce the desired replacement ratios. There are a number of ways to approach this topic, but let me choose one of the more traditional ones and first define benefit formulas under two broad categories: unit benefit and flat benefit. We will discuss unit benefit plans first.

The name means just what it sounds like it means. In each year of service, a specific unit of benefit is credited towards retirement. However, here again we must first categorize the unit of benefit as either a dollar amount or a percentage of pay. Where it is a dollar amount, as is often the case in union negotiated plans, a typical monthly benefit for each year of service might be $10. Under such a plan, someone retiring with 30 years of service would, therefore, receive $300 per month in retirement income.

With regard to those unit benefit plans in which the units are expressed as a percentage of pay, and are, therefore, tied to compensation, we immediately run into three questions which we must answer.

First, what is the definition of compensation? Is it to be base salary only or also include overtime, perhaps commissions, perhaps bonuses.

Second, what is the basis of compensation? Will it be career average or final average salary?

Third, what is the averaging period for compensation, final or highest average 3 years, 5 years or 10 years or other?

Note that all three of these questions have to do with the fact that in defining unit benefit, we brought in the word "pay" and each question relates in some way to pay.

There really is another question to ask regarding the word "benefit" and that is, is the benefit going to be coordinated with Social Security or, as we say, integrated with Social Security or is it not? More specifically, the question should be, is the benefit going to be explicitly integrated or implicitly integrated with Social Security?

Let me elaborate on this latter point for a moment. Today the overwhelming majority of all corporate plans take account of Social Security in one way or another. If the plan does not specifically take account of Social Security in the benefit formula, but takes account of it by providing a somewhat lower overall benefit, it is said to recognize Social Security implicity, or be implicity integrated. Very few corporate plans are of this type. If the plan benefit, on the other hand, specifically takes account of Social Security, by either offsetting a portion of Social Security payments directly or taking account of them in the benefit formula with a lower percentage applied to one portion of pay, and a higher percentage to another, such plans are said to be explicitly integrated with Social Security. More on this later, however.

Now let's get back to the three questions we asked concerning pay. First of all, we must decide what the definition of the compensation base is. Is the benefit to be based only on base salary, or should the compensation base include overtime, should it include commissions, should it include bonuses?

The important thing to keep in mind with regard to any additions to base salary in the compensation base used is, do such additions represent a continuing and regular part of the employee's compensation, as opposed to a sporadic, or occasional increment to base salary? If the increment is continuing and regular, it probably should be included in the compensation base, since it will be an important element in calculating a correct replacement ratio.

If, on the other hand, the increment is sporadic or occasional, it should not be included. In fact, if the employee has some control over the amount of the increment, as is occasionally true of overtime, including the increment can actually distort the intended retirement benefits, as in the case of a final 3-year average salary, where an employee generates unusually high amounts of overtime during his final 3 years of employment, primarily to increase his retirement income. Under the Civil Service Retirement System, the compensation base is almost universally base pay.

The second question we asked referred to the basis of compensation, that is, career average or final average salary. Career average simply means that the unit of benefit which is credited during any year is based upon the employee's compensation during that specific year, for example, 1 percent of actual salary for each year of service.

Years ago, many plans were of this nature, but the increases in the inflationary rate over intervening years have caused most employers to move to final average salary plans, where the unit of benefit is based upon some final average salary, in order to overcome the undesirable feature of retirement benefits which had otherwise already been eroded by inflation before they even became payable.

The flip side of this is that career average plans are less expensive than are final average pay plans and during the recent recession a few companies with final average plans effectively froze accrued benefits, and went career average for future service, with the idea of periodic updates in the future—sort of a throwback to career average but not all the way--in order to reduce costs.

If our plan is a final average salary plan, we now must ask what is the averaging period of compensation? In past years, final average salaried plans, which were designed to keep the benefit related to earnings in a period prior to retirement in an effort to defeat inflation, might have averaged compensation over the final 10 years. As inflation increased in intensity, it became obvious that averaging salary over 10 years, even though working with the final 10 years, still caused an erosion of scheduled benefits due to rapid inflation. Hence, most plans moved to 5-year averaging. In the past 5 to 10 years, we have seen a number of plans change to final 3-year average compensation, although the bulk of plans, by far, are still on 5-year average compensation. The current Civil Service Retirement System is a highest 3-year average salary plan.

Just to illustrate how these three questions relating to percentage of pay can affect the benefit, an employee who retired at age 65 after 40 years of service and was earning $40,000 base pay at retirement would have a career average salary of just under $16,000, if you assumed a uniform 6-percent salary progression. This same employee's final average salary would range from slightly over $31,000 if averaged over the final 10 years up to just under $38,000, if averaged over the final 3 years. These numbers would all increase proportionately if total compensation were used in place of base pay.[1]

The second broad category of formulas, as I mentioned, is flat benefit formulas, where the underlying philosophy is that once someone has been employed a minimum number of years, retirement benefits should not be related to years of service.

Typically, the benefits might be expressed as, say, 50 percent of compensation once an employee completes 25 years of service. Benefits would be reduced proportionately for any service less than 25 years. Incidentally, this type of plan may also be integrated with Social Security, which topic I will discuss in a few moments.

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[1] See table 1 on p. 134.

One other aspect of the benefit formula that I would like to touch on is the pattern of benefit accruals. Although most private plans have the accrual spread evenly over the service period, this does not have to be. If the employer desires to encourage long service or encourage short service, he can alter the accrual rate accordingly.

In those instances where he might wish to provide early retirement incentives, the plan might provide a higher accrual rate for the first portion of total service and a lower percentage for the later portion of service; for example, 2 percent a year for the first 20 years and 1 percent per year for years thereafter, or alternatively, 2 percent per year for up to 25 years of service, and nothing thereafter. These types of formulas are known as front-loaded.

On the other hand, a plan which encourages longer service might be back-loaded. The Civil Service Retirement System is of this type, and provides for an annual benefit accrual of 1½ percent for the first 5 years of service, 1¾ percent for the next 5 years, and 2 percent for all service beyond the first 10 years.

I might just note that in order to discourage private employers from back loading their plans so excessively that they tilt them overwhelmingly in favor of longer service employees who might typically be the higher paid, Congress, when it passed ERISA in 1974, incorporated some accrual tests that qualified plans must meet in order to avoid this type of discrimination. I won't go into these tests today except to mention that there are three different tests and a plan must meet one of those tests with regard to benefit accruals.

I would also note that some private plans provide a minimum benefit in order to assure a basic floor of protection. What about maximum benefits? A number of years ago there generally were no maximums placed on pension plans, but with the passage of ERISA in 1974, Congress specified a maximum limit for qualified private plans of the lesser of $75,000 or 100 percent of a participant's average compensation during the 3 consecutive calendar years of highest compensation. The $75,000 was to be adjusted automatically for the cost of living and by 1982, this maximum amount had risen to $136,425.

Legislation during that year, TEFRA, the Tax Equity and Fiscal Responsibility Act, imposed a maximum annual benefit limitation of $90,000 on qualified defined benefit plans until 1986, and the Deficit Reduction Act of 1984 passed last month by both Houses of Congress has extended this freeze until 1988. As you know, the Civil Service Retirement System has a maximum benefit equal to 80 percent of highest 3-year average salary.

Now let's turn our attention to Social Security integration. The Civil Service Retirement System, for new Federal employees, now faces the question of whether to integrate implicitly or explicitly. Implicit integration would acknowledge the existence of a separate Social Security benefit by providing a lower benefit level for all employees than the current Civil Service Retirement System benefit level. The advantage of implicit integration is that it is simple and easily understood by employees. The significant disadvantage is that it fails to achieve appropriate replacement ratios for all employees unless, of course, most employees are at the same approximate pay level. This is not generally true in corporate plans, and is not true in the case of Civil Service employees. Therefore, it is quite likely that any revisions will explicitly recognize Social Security, that is, recognize the Social Security pension benefit in the Civil Service Retirement System benefit formula.

There are three approaches to choose from in explicitly integrating with Social Security. These were discussed in the third policy forum of this series in some detail, and I, therefore, will simply touch on the highlights here today.

The first method is to offset the ultimate pension benefit by some percentage of the amount received from Social Security. The IRS has issued fairly detailed regulations prescribing the maximum offset permitted. In view of these regulations, most corporate plans utilizing this approach generally end up offsetting 50 to 60 percent of the individual's Social Security benefit. The advantages of offset integration are that it is easily understood by employees and it automatically keeps pace with changing levels of Social Security for successive generations of retirees. The disadvantage is that the employee has the feeling of seeing something deducted from his pension that he feels he has purchased, although from a theoretical viewpoint, this is not true.

Let's take a moment to look at an example of offset integration, since it will serve to illustrate the underlying concept of all Social Security integration. First let's look again at the benefits provided by Social Security. Note that Social Security was specifically designed to replace a higher percentage of income at the lower salary levels than at higher salary levels. To illustrate this, I have shown replacement ratios for a retiree in 1984 ranging from 50 percent at $10,000 to 12 percent at $70,000.[2]

Note that, in order to provide employees with appropriate replacement ratios, which as I noted earlier generally range from 50 to 80 percent, depending on preretirement salary levels, an employer looking at these Social Security replacement ratios would, ideally, not wish to provide lower paid employees with any benefit, while supplementing higher paid employees' Social Security benefits to the extent necessary to attain the 50 percent replacement ratio objective; that is, the employer would prefer offsetting 100 percent of the Social Security benefits. However, since Social Security benefits are financed by equal employee and employer contributions, the IRS, in a complex revenue ruling, limits the permissible Social Security offset.

Let's next consider the actual replacement ratios under a typical private plan which is integrated with Social Security and also complies with IRS regulations. Note that this offset plan provides a tilt in favor of higher paid employees to counteract the Social Security tilt in favor of lower paid employees.[3] However, when this plan's benefits are combined with Social Security benefits, the resulting replacement ratios are actually quite close to the original 50 to 80 percent desired replacement ratios.[4]

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[2] See table 2 on p. 135.

[3] See table 3 on p. 136.

The other two ways that the employer can explicitly integrate pension benefits with Social Security benefits are by using either excess or step rate excess integration formulas. Let's discuss the excess formula briefly since the step rate excess formula can then be more easily explained.

Excess plans, often called "pure excess" plans, simply provide no pension benefits for earnings below a certain level, known as the integration level. Benefits are instead based on a percent of earnings above this integration level.

Obviously, this is to counteract the effects of Social Security, which as discussed earlier, gives more credit to lower earnings than to higher earnings, or as we have been saying, is tilted toward lower earnings. This level of earnings below which no benefits are provided is known as the integration level.

In the same revenue ruling referred to earlier, there are rules covering how this integration level is determined, and there are also rules governing the integration percentages that are permitted. Because the total amount of benefit permitted under a pure excess plan is limited, it cannot be used to achieve appropriate replacement ratios for a group with a broad salary distribution and is, therefore, not widely found in corporate plans, nor would it be appropriate for use in the Civil Service Retirement System.

The step rate excess formula is really nothing more than a variation of the pure excess formula in that a certain percentage of benefit is given below the integration level and a higher percentage given above the integration level.

The concept here is similar to the excess plan, in that lesser benefits are given to the lower paid because of the Social Security tilt in their favor. However, the total benefits that can be provided under this type of integration do enable it to be used in achieving more appropriate replacement ratios for groups with broad salary distributions.

As I mentioned, since Social Security integration was discussed more fully in the third policy forum of this series, I am not going to go into any more detail; however, I would simply note that offset integration is the most effective approach in recognizing the Social Security tilt toward lower paid employees and, therefore, is the most widely used integration approach in corporate plans.

Now let me turn very briefly to defined contribution plans, since these were also covered in some detail in the first policy forum. The underlying and extremely important basic difference between defined contribution and defined benefit plans is that under a defined contribution plan, the employer does not undertake to provide retirement benefits of any predetermined amount, as he does in the case of defined benefit plans. Instead, the employer's contribution is defined, as opposed to the benefit being defined. The employer does undertake a fixed or defined contribution commitment, generally a percentage of salary, and funds, consisting of these contributions, are allocated individually to employees to accumulate at whatever investment return might accrue from the investment of these funds.

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[4] See table 4 on p 137.

At retirement, the accumulated contributions, with investment return, are made available to the employee; this amount may be made available as a lump sum, or applied at the then-current annuity purchase rates to provide whatever amount of retirement income the lump sum will purchase. Note that in the defined contribution plan the total investment risk falls on the employee, as opposed to defined benefit plans, where the employer bears the investment risk.

Probably the single biggest disadvantage of defined contribution plans is that they do not produce an appropriate replacement ratio for all employees, since the amount accumulated at retirement depends on the period of accumulation and the investment earnings.

Another disadvantage is that it is difficult to estimate the retirement benefit with any degree of precision, which makes retirement planning somewhat more speculative than with a defined benefit plan.

The biggest advantage of defined contribution plans, aside from their simplicity, is that if a person changes jobs often, he will likely be better off under a defined contribution plan than under a defined benefit plan since vesting generally occurs earlier in defined contribution plans.

For example, currently someone in private industry could have jobs with four different employers, serve 9 years with each, and end up with no benefits if the vesting were 100 percent after 10 years of service in each of those plans. This type of situation would not normally arise if all employers had defined contribution plans. However, we should keep in mind that we are talking about a Civil Service retirement plan which is primarily designed for career employees, and which currently vests 100 percent after only 5 years of service.

With regard to some of the points mentioned earlier regarding benefit formulas, as they pertain to defined contribution plans, let me simply say that you don't find any back loading or front loading in defined contribution plans, and the offset Social Security integration approach is not permitted; however, both the excess and step rate integration approaches are. As an example, this year the employer can contribute zero below and 5.7 percent above the integration wage base in a defined contribution plan.

One other difference is that in defined contribution plans, when defining the benefit formula, the normal retirement age is of considerably less significance than in the case of a defined benefit plan.

Finally, I was asked to note briefly the effect of benefit formulas on a combination of the two plans. In the private sector, by far the majority of larger employers have utilized defined benefit pension plans integrated with Social Security as their basic retirement scheme in order to provide the desired replacement ratios for their employees. They have then supplemented these basic defined benefit plans with defined contribution plans, generally of the so-called thrift plan variety, where the employer matches some percentage of employee contributions, both made on a defined contribution basis.

This approach strikes me as eminently worthy of further investigation for Civil Service employees, since I do feel that the positive features of a defined benefit plan—most specifically, that of being able to design a plan which will provide appropriate replacement ratios—is of paramount importance in any well-designed retirement scheme, and I do think Civil Service employees deserve a well-designed retirement plan.

The advantages of a defined contribution plan, which could be supplemental, would be to then encourage employee savings, and also could be considered as a way to provide supplements to the basic defined benefit plan—instead of the current automatically indexed cost-of-living increase—to act as a hedge against future inflation after retirement; but then, cost-of-living adjustments is another whole topic and is the subject of our last speaker today.

As you will note from the discussions which follow on retirement ages, death and disability benefits, vesting and cost-of-living adjustments, many of the various aspects of plan design are interrelated, and directly affect the cost.

Hopefully, this final forum will provide you with additional insight as to the relative importance of each of these factors, both from the benefit design aspect, and as well with regard to their ultimate impact on plan costs. Thank you.

Mr. SHIPP. Are there questions for Mr. Garrett? Bob Myers.

Mr. MYERS. Have any private plans given thought to a different type of average wage than either of the two you mentioned—namely a career average, but compute it on the basis of indexed wages? It seems to me this has a great advantage over the final-wage type of plan, where two people can have the same final wage, but quite different life histories.

Mr. GARRETT. I think there has been more experimenting going on in the area of career average plans recently. As I indicated, with the recession and so forth, people are looking at them and some companies put in plans in which they effectively communicate to employees that they will be updating these periodically.

I am not familiar specifically with any of the type you mentioned, but there may be.

Ms. BENSON. Helene Benson, Professional Managers Association. I have more of a comment than a question. As I understand it, there seems to be another disadvantage to explicit integration in defined benefit plans in the private sector that we ought to keep in mind in designing the plan for new Federal hires, and that is, right now in the private sector, the integration formulas can take into account the Social Security benefits that an employee earns during his entire career. Each employer can take the entire Social Security amount into account instead of just the Social Security benefit that the employee earned with that particular employer so that an employee who becomes vested, say, and changes jobs every 10 years, could wind up really with little or nothing from each one of those private sector plans.

This doesn't happen to a long service employee. Since one of the advantages of covering new Federal hires under Social Security is that they are not supposed to be tied with the golden handcuffs that present employees are, I think we should make sure that any integration formula explicitly recognizes only the Social Security benefits that the Federal employee will earn while in Federal service.

Mr. SHIPP. Do you want to respond to that?

Mr. GARRETT. No.

Mr. GARDNER. You stated earlier that the Civil Service Retirement System is fully indexed for inflation. We keep hearing that. That, of course, is not currently true. It was for many years, but because of various caps on annuities and delays, that is not currently the case.

Mr. GARRETT. It is more fully indexed than certainly any private plan that I am aware of.

Mr. SHANEFELTER. In the corporations that we talked to which have offset plans, what they consistently advised us against was offset plans vis-a-vis step rate plans because of the complexity involved in it.

When you talk about the most efficient way of recognizing Social Security as being the offset method, Mr. Garrett, do you take into consideration complexities of administration?

Mr. GARRETT. That is certainly a consideration. In talking about the offset plan, I was concentrating on trying to achieve the most effective replacement ratio. You find with these other types of integration you have to keep updating them because of the rapid increase in the Social Security base.

I would agree administration is going to be a consideration.

Mr. COWEN. Harper, with regard to a combination plan, you talked about regardless of the type of plan used, the plan should have a certain replacement rate objective in whatever benefit it provides. If an employer is using a combination plan, should the employer's defined benefit plan meet the full replacement rate objective or should they together meet the objective?

Mr. GARRETT. Let me answer that the way I would look at a private plan, and it is the way you would consider Civil Service. I would think a defined benefit plan should try to meet the full replacement ratio at retirement. I would then consider the defined contribution approach could be used as a substitute for the automatic index linked to the cost of inflation. It is certainly the way the private industry, I think, views this.

Mr. SHIPP. More questions?

Mr. LOSK. I want to comment on the definition of pay. In any retirement plan where the averaging period is relatively short and pay is not well-defined, elements of pay that were not intended to fall into the formula somehow get there. For example, there are public sector retirement systems in which payoffs for unused sick leave, unused personal leave, et cetera, are folded into a high 2- or high 3-year average and have an effect on benefits.

I just should indicate that it is extremely important that you well-define pay in any defined benefit retirement system, and the shorter the averaging period, the more important that definition is.

Mr. GARRETT. I would concur wholeheartedly with that. I guess the classic horror story in this—I live in New York City and I am still paying for the settlement in 1966 with the transit workers where they used final 1-year average, including overtime, and everybody worked overtime that last year, and the replacement ratios were out of sight. The cost was even more out of sight.

Mr. LYNN. Peter Lynn, GAO. In one of your earlier slides, you showed the cost of a life annuity, indexed at 5 percent, increasing by 44 percent. Can you tell us what interest rates you used on that and what the basis for it was?

Mr. GARRETT. Yes, that was 8 percent, 1971 Group Annuity Mortality table.

Mr. CASTELLS. I really have more of a comment on a couple of previous questions. Bob Myers asked about whether any private sector companies had used the idea of indexed career average earnings. I know of a couple private sector companies of some consequence that have career pay plans where the accruals are indexed to investment return. In fact, they have a variable benefit, very much in line with the TIAA/CREF idea during active employment.

The second comment is with regard to use of offset plans in the private sector. Most companies that use offset plans in the private sector, and this represents most companies in the private sector with pension plans, use estimated Social Security benefits. Essentially what that means is that they will take whatever pay information they have in their files and back off from that to create a total Social Security benefit for the career of the employee. Recently, the IRS issued some regulations requiring that if the employee, by providing the actual records of his back earnings, can show Social Security is less, that his benefit would need to be adjusted. I don't know what proportion of people would be bringing in those Social Security records, but the administration, on the basis of these estimated Social Security benefits, is not particularly complex.

Finally, Jamie had a comment regarding replacement ratios, whether or not we would want to use both programs in terms of the minimum replacement ratio or the replacement ratio you would want to achieve. Many companies will set a minimum replacement ratio as an objective and then provide the ability for their employees to do better than that.

In effect, if you want to have a Cadillac after retirement, you can contribute toward it; if you want to have a Chevy after retirement, you have a middle objective. Many companies would have a defined benefit plan which will provide the Chevy. If you want the Cadillac, we will help you buy it, but we won't subsidize the entire amount.

Mr. GREENOUGH. I have always been puzzled as to why, in giving a definition of defined contribution plans, it is uniformly said the total investment risk falls on the employee, and it is rarely added that the total investment reward accrues to the employee.

Mr. GARRETT. I accept that addendum. It should be said; it doesn't go without saying. However, I guess I remember, in fact I can relate to your background, during the 1960's and the time of the CREF variable annuities, people always seem to accept the increasing annuity checks as the way things are supposed to be, and it is only when you drop the amount of the checks the first time that you get scores of complaints; you didn't get any letters of praise when the amount of the checks went up.

Mr. GREENOUGH. That is not correct, but we won't get into that. I had to correct one of our own officers in this seminar who had said the total investment risk falls on the employee and did not mention the reward.

Mr. SHIPP. Yes?

Mr. COHEN. Alan Cohen, Senate Budget Committee. The comment was made that you could use a defined contribution plan as a way of covering for the problems of not indexing a defined benefit plan and that this has been a useful way in the private sector of using a combination of the two plans. To what extent do you feel that this is a rather crude approach to indexing a defined benefit plan? If you want a system which provides an adequate minimum benefit using the defined benefit approach, do you feel that if you don't have it indexed, that you won't really accomplish that objective, especially if you are relying on a defined contribution plan as a proxy for that indexing?

Mr. GARRETT. There is no question that using defined contribution supplements is a cruder approach than indexing right to the CPI. However, as I tried to indicate on the slide on accumulation, the cost of the direct indexing is really much higher than most people realize. The defined contribution approach, again, is going to depend on the investments and as was pointed out, to the extent the investments are done wisely, tied in such that the inflation underlying CPI and investments is there, they should track. It won't be perfect; there is no question; no question.

Mr. THARP. Charles Tharp, Pension Benefit Guaranty Corp. As long as we were stating the obvious about defined contribution plans, perhaps I should add that on defined benefit plans, the employer bears the risk, at least 30 percent of net worth as defined, and also in the case of termination where there are excess assets, will reap the reward.

I am not sure what the anology will be in context of the Civil Service Retirement System for an excess, although that may be a theoretical question and not an actual one.

Mr. GARRETT. I wouldn't see the taxpayers terminating your plan to recover the assets. I think this phenomenon we have seen recently of the asset reversion is one that has raised an interesting question and recently has been resolved by some guidelines. You go through cycles on this thing, as I think anyone who has been in the pension or investment field knows. This recent rush for reversion of assets is an interesting phenomenon when you just look back a few years to the Fortune Magazine panic article about unfunded liabilities, and so forth. How did we swing over to discussing excess assets, in such a short time? I could spend a lot of time on that this morning, but very briefly what has happened is—you have had a number of things happen, not the least of which is the Financial Accounting Standards Board's requirements for pension reporting on private plans. Most of you maybe are not following this in the private industry; this is becoming another very important factor right now. FASB just issued, July 3d, some disclosure requirements on post-retirement welfare and life insurance, which are really causing people to look at these benefits.

Getting back to the point I was trying to make, this thing swings back and forth about whether you have surplus assets. Most plans are funding on what is known as a level basis, prefunding similar to ordinary life versus term life. They always had a surplus when viewed on a termination basis. This surplus has just been exacerbated by the rise in market value of assets, and the higher interest rates used to value the liabilities, which lowers the liabilities, and makes it look very appealing.

This has all been intensely compounded by the recent acquisition fever which we have seen in corporate America. People are actually acquiring companies, and we saw a major firm terminate the acquired company's pension plan after the takeover to help finance the takeover, because of surplus assets. These things will swing back.

I think most employers look at their pension undertakings as a long-term investment and are going to continue to fund it. Once you take the surplus assets out, in most cases, you are going to increase your future deposits if you reestablish that plan, because you have taken out the excess.

Mr. SHIPP. We have time for one more question.

Mr. LOSK. Harper, I recognize your discussion was very general and conceptual in nature. It is, also, quite possible this question was covered in an earlier forum. However, I wonder if you would care to comment on the question of what Social Security benefits should be recognized in building replacement ratios? It has been a number of years since Revenue Ruling 71-446 and the Social Security system and the nature of society have changed a whole lot in that period. I wonder if you would care to comment in that area?

Mr. GARRETT. Well, I guess, one thing is, as you know, 71-446, which is the revenue ruling I was referring to in my remarks, really has come under attack a number of times as being outdated, as being based on principles which no longer apply, and so forth.

Periodically, we do see moves to change that in the private industry. We will probably see that within the next year or two in various proposals in Congress.

Basically, I think the underlying principle of the employee/employer contribution being equal still applies. There is no question but that the integration rules could be greatly simplified; Revenue Ruling 71-446 is an incredibly complex document. Basically what could be accomplished in the private sector would be to simply take account of half of the Social Security benefit as being the acceptable or permissible offset amount.

Right now you start off in offset plans with something like 83⅓ percent as the maximum offset under optimal conditions. By the time you take account of ancillary benefits, you get down to the 50 percent, 60 percent that I mentioned, which is actually offset.

Federal plans, not coming under the Social Security integration rules, could well, as was suggested in the third forum by one of the speakers, consider 100 percent offset. I think that does raise certain questions of explaining it to the employee, but that certainly will accomplish a more perfect integration.

Mr. SHIPP. Thank you very much, Mr. Garrett. We will move now to our next topic which deals with retirement ages. The presenter is Mr. William Greenough, a distinguished name in the pension field. Many of us learned our early lesson about pension issues from reading his books and knowing about his work.

Mr. Greenough is a Hoosier by birth. He received degrees from two fine universities: A.B. and LL.D Degrees from Indiana University; A.M. and Ph.D. in economics from Harvard University. He was President or Chairman of the TIAA/CREF from 1957 to 1979. In 1951 he wrote a study called "A New Approach to Retirement Income" that led to the establishment of CREF.

Mr. Greenough was a member of the President's Commission on Pension Policy; is Chairman of the Subcommittee on Retirement Policy of the Committee for Economic Development; is a member of the boards of Aspen Institute for Humanistic Studies, Radcliffe College, Indiana University Foundation, Carnegie Institution of Washington, and the Council of Rockefeller University.

I am very pleased to present Mr. William Greenough.

B. Retirement Ages

(Presented by William C. Greenough, Retired Chairman, Teachers Insurance and Annuity Association/College Retirement Equities Fund)

Mr. Greenough. I wonder if anybody else would like to stand up and stretch as much as I do? That felt good when I stepped up here.

Thank you. I, first, Jamie, would like to comment favorably on the idea of these forums. A number of us I see around the room have testified in Congress where you sit down there at these little tiny things and look up at the great Supreme Court bench and have all these people looking down at you, insofar as there is anybody there. In these forums, when you testify, of course, people are there. I think it is great to have the large amount of informality and chance for discussion and interchange that these provide, and I hope this will be imitated in other areas.

In discussing retirement ages, I don't plan to present data. Your committees have access to exhausting data as to retirement ages used in various employments and the age at which people actually retire under Civil Service, Social Security, and other retirement plans. Our job here, I think, is to contemplate what ought to be retirement ages for the next 20 to 40 years for new employees under Civil Service and to work toward that objective.

My job was outlined to me as discussing issues of particular interest, such as the impact of retirement age on personnel policy, social policy, and cost. So I will try to do that.

I will first start with a nice fatuous remark: The ultimate purpose of a retirement plan is to make it feasible for employees to retire in a socially acceptable manner at an appropriate age. Well, sure, that simple statement, though, has very broad ramifications. The full objective of a retirement plan is to achieve a productive working force, best achieved through fair treatment of the individual workers covered by the plan, the employer, and society.

A major problem in discussing retirement ages under the proposed new Civil Service retirement program is the very broad scope of Federal employment, the many kinds of skills, interests, experience, attitudes, vigor, and ability needed, and the competition for productive talent with private enterprise, nonprofit employment and other governmental work.

Another problem is that many people approach the question of retirement age from opposite perspectives. The first is personal, introspective. Some people want to get out as soon as possible; perhaps they don't like the jobs they are in or they want a different, second career, or to enjoy leisure. Others love their jobs, or are workaholics and never want to retire, or think they never grow old.

Personally, I can proclaim at age 69, I am as good as I ever was at age 29, 39, or 49. But even my wife has a better memory than that. And attitudes will differ according to the physical and mental requirements and stress of a job, the attractiveness, the pay and the fringe benefits.

The second perspective is objective. That is, when should the *other* fellow retire? "Most people are slipping by the time they are age 65 and should be retired." Or "People age at very different rates—there should be objective tests of physiological age." Or "The job requires youth and strength, so should carry a low retirement age." Or "People ought to be allowed to work as long as they want to."

All of these analyses and concepts and ideas support the idea, in my mind, of a flexible retirement age for Federal service. During the last 100 years, both our laws and our social attitudes with respect to retirement age have been increasingly skewed toward employer attitudes.

Most pension plans had a compulsory age, usually age 65 in private enterprise, without flexibility. Two major demographic trends gathered force during this century. The first is the trend toward more and more men—it really was an age of male employment—withdrawing from the labor force at age 65 or even earlier. The 100 years opened with perhaps 70 percent of employed men beyond age 65 staying in the labor force. It is closing with perhaps less than 15 percent in the regular force.

Precisely half way through the 100 years, Social Security was developed, partly to get the old people out of competition with the younger during the Great Depression. At the same time that this trend was occurring, far more people, both proportionately and absolutely, were living beyond retirement ages, beyond the normal retirement ages. So the number of years spent in retirement has been increasing dramatically.

The retirement age in the present Civil Service retirement program can be considered an extreme product of this history. In fact, the age 55 with no reduction in benefits after 30 years of service will undoubtedly prove to be the nadir of the trend of the last century.

I think it is really good luck that the matter of retirement ages in Federal employment is being considered at this time. Monumental labor market and attitude shifts are already occurring. A major change is that just last month we reached the point at which one-half of working age women are employed in America. A significant social change has been in the attitudes toward retirement. ADEA outlawed compulsory retirement ages under 70 in most American employment. More and more States are uncapping retirement ages. So far, workers have not caught up with ADEA. They are still retiring earlier and earlier, but I believe the time has come when demographic, social, and economic factors will reverse the trend. Let me allude to some of the primary factors.

One, the cost lever. For pensions, as has already been shown on the board, retirement age is the most important single cost factor. It determines whether a pension will be paid for a couple, wife about 2 years younger, on the average, for about 22 years, age 70 retirement; 26 years, age 65 retirement; or 34 years, retirement at age 55. I will be glad to give Bob Myers my references for that when he debates the half years.

All of us as participants in this forum know the figures. To quote only one, it costs about twice as much to retire at age 55 as at age 65. Practically all the studies on governmental retirement plans—the President's Commission, GAO, Committee for Economic Development, Grace Commission, advisory commissions, these seminars—have placed heavy emphasis on the high cost of early retirement without actuarial reduction, and have recommended change.

Second, getting the Federal work done. It is now pretty well agreed that the very early retirements taken by so many long-term Federal employees are costly not only in financial terms but also in terms of getting the Government's work done, and perhaps to the feeling of usefulness of many individuals also.

Full-benefit retirements at early ages lead to loss of experience and expertise that is very difficult to replace. Turnover is expensive in itself and the Government, unlike the private sector, is losing 7 to 10 years of productive service between ages 55 and 62 to 65.

So from the standpoint, to answer the first question I was asked, of addressing the personnel needs of the Federal Government, a higher retirement age would seem indicated as advantageous to the individuals, to the Government and the taxpayer interests. Of course, this doesn't mean that everybody who is over 55 is in good health and a good employee, but we are speaking in generalities.

Second, distribution of life-time income. Government compensation has not always followed the most effective nor the most rational bases. That lack of rationale is not limited to the Government. The failure to take total compensation into consideration helped to lead to this situation. For many years, especially in the Great Depression, Government employment was probably substantially underpaid. Recompense was made, as so many studies show, by overly generous retirement arrangements, with the cost deferred. This meant that the Government was forcing on its employees a lifetime distribution of their total earnings that may not have been in their best interest.

In recent years, it has resulted in heavy retirements from Federal service at age 55 with 30 years of service since there is little financial gain from staying beyond that point.

Wage compression at top governmental levels and pension escalation have exacerbated this situation. This heaping up of salary income below certain ages, and annuity income beyond those same low ages, does not necessarily treat employees or the Government best. A system providing appropriate pay for a longer period of employment, followed by good retirement income for a reasonable period, would seem to be much better.

Longevity. Otto Von Bismarck got a very good press 100 years ago by putting in retirement benefits at age 70 in Germany, later moved to age 65. How many of the rest of you have had to suffer over decades from the fact that Bob Myers does read your material? It is absolutely great, but he called me on that age. I said Bismarck had used age 65. Of course, it was wrong; he used age 70. One hundred years later, 28 million Americans are living beyond age 65 and the great majority of them are retiring.

Hopefully, improving longevity means not only longer life, but longer life in good health, which once again suggests later retirements instead of earlier.

Multiple wage earners in the family. A vast social change in the opposite direction in very recent years has been the number of women in the labor force, and of multiple wage earners in the family. This factor alone means that many people can, if they wish, retire earlier since two incomes are supporting retirement arrangements instead of only one, and there is not the same need for early high benefits from Civil Service or other plans.

Youthful employments. During this century, it has been assumed that the military, police and firemen, intelligence, and such occupations, are hazardous and deserved very early retirement. This probably doesn't make much sense anymore. An increasing number of military and other such jobs call for sophisticated mechanical and electronics knowledge and ability and other refined information. Now it is true that these employments may well be considered "youthful employments" on the whole, but to act as if such employees are through, are washed up at age 38 to 42 and to provide generous retirement benefits for the entire rest of their lives is, well, a stupid way to handle it. It would be much better to provide good salaries during employment, good retirement benefits starting at age 65 and in between shift to different duties as age advances, or provide generous relocation, retraining, education and other such grants upon shifting employment.

Flexible work arrangements. We have puzzled over that for a long time. Maybe it is time to go to work on it. Perhaps the Federal Government has an especially challenging opportunity to point the way for employment in America. It has already eliminated mandatory retirement for its employees, but it has made little attempt to change its own job structure. Job patterns are incredibly frozen, 9 to 5, 5 days a week, 50 weeks a year, or whatever the particular pattern is. Seniority, union rules, employers, regulation, all prevent flexibility.

Under such rigidity, of course people burn out, get bored, fed up. Perhaps the Federal Government should lead us toward flexible work arrangements through restructuring jobs for people above certain ages. This could include tapering off, shift to part-time or flexible hours, retraining, different work assignments above age 55, 60, modem connections to home computers, perhaps even coming to grips with tapering off of earnings as well as duties. This is not an easy area in which governments can innovate, but as the opportunity to work gets pushed up higher and higher, to higher ages under ADEA, perhaps changes must be tried.

Later retirement ages. Practically all the factors suggest, for the coming 20 to 50 years, in my opinion, a higher and more flexible retirement age for participants in the new Federal Civil Service retirement plan. I believe this will be in the interest of employees, the Federal Government and the society. I believe it will be in the mainstream of development of employment patterns, utilization of skills of older workers, and the social thrust as indicated by ADEA and trends in private retirement ages. And it fits with the demographics of baby booms, dependency ratios and financing of retirements.

This conclusion, again, is consistent with the preponderance of current recommendations on retirement ages. And you know the various references of the various groups that have studied such. There is one quotation that summarizes much of the foregoing, and it does it in such succinct language and great clarity that I want to read it. I wrote it originally for the CED and I find myself quoting it—well, it is one way to get your own stuff out in front of people, but I won't read it at this point.

Just as employers must become flexible in work arrangements, employees must take responsibility on themselves to avoid physical and intellectual obsolescence if they are to be ready to shift job assignments and patterns at older ages. There has been a good deal of namby-pamby thought—"let people work as long as they want to"—without taking into account employer interest, and this is especially difficult to handle in governmental employment.

In conclusion, if this forum in 1984 were taking up the question of retirement ages without historical background at all, I would hazard a guess that it would recommend a normal retirement age for Civil Service of somewhere between ages 68 and 72, just a guess. But not an uninformed one. This age would fit with demographic facts, with improvements in longevity, the social philosophy of ADEA, realities of Government employment and with financing practicalities. We shouldn't be a victim of our history, but we sure do need to take account of it. Hence, perhaps a more acceptable arrangement would be to make no change in retirement age for present members of the retirement system and to choose, for new members, age 65 as normal retirement age, moving upward in tandem with Social Security.

Coordination between plan retirement age and plan design. I will refer to that very quickly because all of you know there is a very clear impact of the type of retirement plan on what you can do on retirement ages. But in order to achieve the objectives suggested for the future, a three-layer plan, like the ones under primary discussion in these seminars, would seem to be fair, flexible, useful and appropriate, even if a bit complex.

The required parts of the three plans could be designed to provide for new Federal employees the appropriate level of benefits at age 65, which would be considered the normal retirement age. There would be no restrictions on when employees could start their benefits once vesting occurred. For retirements below the normal age, all benefits would be actuarially equivalent to the age 65 benefit. For retirements after that age, full accruals of benefits would be provided under the defined contribution plan. No additional accruals would be provided under the defined benefit portion and the Social Security portion would follow the standard Social Security formulas. This pattern would give ample incentive for people who wanted to work to continue after age 65.

Recommendations. Thus, the retirement ages and benefit plans would look generally like the following, with any specific details, of course, open for discussion.

One, Social Security, first level of benefits, as you have been discussing, with its early retirement age of 62, normal age of 65 and a gradual upward movement of the retirement ages under the Social Security Act.

Two, a second layer of Federal Civil Service retirement benefit would be provided, again for new employees, by a modest defined benefit plan paid for by employer contributions only.

Full formula benefits would be available at normal retirement age of 65, reflecting all years of service. Benefits would be actuarially reduced for early retirement. There would be no accrual of benefits above age 65, except for increases reflecting salary changes.

Three, the third layer would be a defined contribution plan paid for by employer and employee contributions, designed to bring benefits up to the appropriate target level at age 65. Employer contributions would stop at that age.

Voluntary supplements. Again, you have been discussing these and I think they make all kinds of sense. With the flexible retirement ages recommended above, flexibility should also be permitted in retirement savings. The defined contribution plan provided above is an excellent mechanism for that. Do it through the defined contribution plan. It can allow an employee maximum opportunity to make his own decisions as to allocating part of his lifetime earnings between preretirement and postretirement income. If he wishes to retire quite early, let him make the maximum contributions to the voluntary part of the plan. If he wishes to retire later on a generous income, he could do the same. If he wished to retire earlier or later but with less generous retirement income, he would make little or no voluntary contributions.

A specific suggestion, as already discussed, would be a voluntary plan with the Government matching one for two the amount saved by the individual up to a Government maximum contribution of, say, 3 percent of salary but with no limit on individual contributions.

One additional thing is needed for Federal employees. Federal employees should have the ability to defer taxes on both their required and their voluntary annuity contributions up to the same limit as available to certain private employees.

I believe this is the direction in which the discussions as to a Civil Service retirement plan for new employees hired after January 1, 1984, are moving. I think I am just reflecting in general much of the direction of mood. Of course, there are controversial ideas, but I think this is in the main swing. It allows all present employees to continue to their eventual retirement without change in the rules of the game. By the way, I think careful attention should be given to allowing all persons under, say, age 45 to choose either to stay with the present Civil Service plan or shift to the new one. But that is just tossing in a freebie. It provides for all new employees a very different but much more currently appropriate plan with maximum flexibility, as is socially required now, both in their choice of a retirement date and in their level of savings for retirement income.

Summarizing recommendations. No change for present Civil Service employees.

For new employees, normal retirement with full benefits at age 65, moving upward in tandem with Social Security.

Second, for retirement before age 65, actuarially reduced benefits that can start at any age after vesting occurs.

Third, for retirement after 65, regular Social Security increases, no further benefit increases except those related to salary increases for the defined benefit portion, and regular actuarial increases without any further employer contributions for the designed contribution plan.

Mr. SHIPP. Are there questions?

Mr. DUBRIN. Harry DuBrin, formerly with New York State Teachers' Retirement System. In your conclusions you suggested, as was suggested in earlier comments before this forum, that there has been some concern expressed over the Federal Government being given a broad range investment responsibility and its effect upon the overall economy of the Nation, perhaps in the sense of control as well.

Would it be your recommendation then that in that area, that the plan ultimately adopted should have its investments handled outside of the Federal Government?

Mr. GREENOUGH. I think what you mean is the investment decisions would be made by some kind of a free-standing, non-Civil Service employee, not to hit Civil Service, but to make it a more impartial structure of some sort. The New York system 20 years ago, I suppose, went outside for investment managers. A number of—I think you were the first—a number of States throughout the country have recognized the real problem if you have civil servants who are under the plan, and all that, doing the investing. There are a number of problems that we won't get into.

I would think that if a fully-funded defined contribution plan, or a fully-funded defined benefit plan, either one, were set up, the Federal Government should think very carefully about how to bring in the investment advice and probably end up with having several investment managers—not to compete with each other, but with different styles—handling the bonds, mortgages, common stocks, equities, and other aspects of the plan.

If you are also asking the second question, a fully-funded Federal plan would be huge, it would have a major impact on investment markets. I think, as I puzzle over this, my own unhappy conclusion is that the defined benefit part of the Federal plan probably isn't really going to be fully funded so that you are only talking about the defined contribution plan and for many, many years the amount of money in that would not be such as would overwhelm the capital markets.

Mr. SHIPP. Allen Johnston and then Hastings Keith.

Mr. JOHNSTON. Allen Johnston, House Aging Committee. I was interested that, in your proposal, pension accruals might stop at age 65, even though you move the normal retirement age up and might want to allow people to work past age 65. Is that an endorsement, for instance, of the ERISA provisions which allow private firms to stop pension accruals at age 65?

Mr. GREENOUGH. The reason for it is that the leverage of continued accruals is really very great. In the defined contribution plan, you are going to have those accruals of past contributions, so I would stop further employer premiums at age 65. Actually a person should not have to start his defined contribution benefit when he retires. He ought to be able to let that ride, if he wants to, for a while. Those accruals are going to occur. You can't really take them away from participants.

Now, the leverage on hanging on to that job after 65 for financial as well as other reasons is so great that I would also stop accrual of further benefits under the defined benefit portion at 65. My own preference, of course, is that each year of employment should finance that year of retirement fully, and it doesn't matter whether it is the year 68 or year 32, or what it is. But here I think, pragmatically speaking, that it would be much more difficult to retire people, to get people to retire at a reasonable age unless you do stop accruing benefits, solely for that.

Mr. Shipp. Hastings.

Mr. Keith. Would you elaborate a little bit on your view as to what people in my particular situation—of which there are perhaps 1 or 2 million—who, after they retired at an earlier age than is customary in the private sector, get an indexed pension. Then they became fully qualified for Social Security and got an indexed Social Security benefit and that now is increasing the liabilities of the Federal retirement plan by billions of dollars. The military and civilian Federal plans already are unfunded. There is about $500 billion of unfunded liabilities for the civil servant and about $500 billion for the retired military. Of course, the funded amount would be somewhat larger so that it represents tremendous amounts of capital from which Federal retirees are getting a very good return.

I would like to have you justify or comment at least on why someone in those positions should get fully indexed their entire pension? Why shouldn't there be a ceiling on that amount of the pension that is to be indexed, such as the cost-of-living portion of it, primary Social Security benefit?

Mr. Greenough. Two or three comments. You asked me to elaborate on that. I think you did a good job of elaborating on it, so I need not do that.

Mr. Keith. I could go on at much greater length.

Mr. Greenough. Yes, I understand that. Second, how did I get set up for that question? I am talking about retirement ages, Hastings.

Mr. Keith. You want to leave in position the present plan which permits 40 percent retiring at age 55 or younger and you allow continued——

Mr. Greenough [interposing]. You are commenting on my statement that leaves the present plan as it is for present employees?

Mr. Keith. Yes.

Mr. Greenough. I will handle that one. Many, many years ago I decided that you better leave a plan inviolate if you can for all the people in it at a given date. Sometimes you can't. There may be political decisions taken that the present Civil Service plan with 60 or 70 percent of civil servants getting Social Security on top of it, being OK'd for it, is too generous. But I think if that decision were to be taken, it should be separated from this particular decision of where we go for new employees at this time. I can go a little farther than that. I served on three or four commissions to bring Federal Civil Service under Social Security over the years—way back, many years ago. On the President's Commission, I took—somewhat to the surprise of some of my colleagues—the position, don't change the present plan for present employees, but for heaven's sake, let's get on with the job of having the kind of a plan we should have for new employees for the future. Turnover in the Federal Government is really pretty heavy and after a few years, you have run out of a good deal of the problem.

If we had taken that attitude 40 years ago, we wouldn't have the current situation at all. So it's a pragmatic view of leaving the plan as it is now, not getting involved in change on that. If you want to take that up politically, let's wait until we get a good plan in place for the new employees. Very pragmatic, or chicken, if you want to call it that.

Mr. KEITH. It may be chicken, but it isn't chicken feed and the cost of it is quite great in social and financial terms.

Mr. SHIPP. Question over here.

Mr. LOSK. I would like to go back to the first question, Mr. Greenough. Basically you suggested a three-layer approach with Social Security being the basic layer and two programs, defined benefit and defined contribution plans, comprising layers two and three. Recognizing fiscal problems and the emerging demographics, the Congress has built substantial incentives, which escalate over time, into the Social Security portion of your program to encourage people to remain at work well beyond age 65.

In your other two layers, you provided disincentives to go beyond 65. I wonder if you could amplify on how those two relate?

Mr. GREENOUGH. What are the disincentives?

Mr. LOSK. The elimination of benefit accruals and elimination of employer contributions at age 65.

Mr. GREENOUGH. You call them disincentives if you want to, or you can call them an effort to be as neutral as possible above age 65 between the pressure to continue and the pressure to retire.

As you know, in a defined contribution plan with good investment earnings, each year you delay retirement will increase the benefits some 9, 10, 12 percent, depending on the length of service, and so on. That is quite an incentive, just riding there without additional contributions, to stay.

So I don't think it is a disincentive to continue; it is a lack of heaping up incentives to continue under the defined contribution plan.

Under the defined benefit plan, again, it is an effort to get it as close to neutral as you can, not again to make it tremendously important for people to stay on, financially speaking, beyond that age. I think our problem is going to be in the future, getting people out on time.

In my area of expertise, the college people, college people like to work and a faculty member's job is high prestige, interesting and everything else. The hardest working people I know are college faculty members—some of them really work hard. And some of the least hard working people I know are faculty members. You can do it either way in the college world, and it is very difficult to push them out.

So if they can hang in there, they can taper off their duties kind of at their own will. This kind of thing can happen in Government employment, too. So what I was trying to do is not put disincentives to continue. Maybe that would be good. I don't think we should do that with the retirement plan. But not to add a level of incentive that is so powerful that it keeps everybody at work until they drop.

Mr. Shipp. We have time for two more questions.

Mr. Gardner. Fortunately, as many of us in the Government and Congress now know, many of the—unfortunately maybe not outside the Government—now know that many of the cost figures from the Grace Commission are grossly distorted. However, to avoid maybe a problem in a current fund from spilling over into the new fund, what is the possibility of— through legislation and perhaps monitoring by GAO and others—the possibility of ensuring that the Government contribution each year is made so that the compounding effect of interest can take effect?

As many of us know, that is a major problem for the current deficit in the current fund. It seems to me perhaps it is more than just an administrative problem to ensure that problem doesn't spill over into the new fund.

Mr. Greenough. It is why some people would have a much larger defined benefit part of this three-layer cake we are talking about than I would. In the defined contribution part, you have to make the contributions. So there is a discipline within defined contribution plans on the employer, whether it is governmental, or college, or whatever it is, that makes it fully funded, and there is really trouble if you don't put that money in it.

So I would make that part larger. On the defined benefit plan, your problem is very real. It has been real in the States. It's been real in the Federal Government. The idea that Federal Civil Service and Social Security are somehow comparable because they both are a federally structured plan is erroneous, I think. The State of Illinois years ago decided it would not even put up the amount of money needed to pay benefits during the next 3 years—it would cut it back to one biennium for actual payments of benefits, let alone any funding, the answer being, "come on, you work for the State of Illinois; don't you believe in our credit?"

I don't know any solution to that problem, except to go into the new plan with as good and realistic funding as possible. I would, of course, extend ERISA and TEFRA to all governmental plans other than Federal; would have done that quite a long time ago.

It is kind of funny for the Federal Government to extend those laws to itself, but I think it would be a good idea if it could be done.

Mr. Shipp. Last question, Andy.

Mr. Ruddock. Andy Ruddock, National Association of Postal Supervisors. I have first a comment and then a question.

It was my understanding today was to be primarily a presentation of alternatives available for consideration, with elaboration on the implications of choosing various alternatives. In your presentation, I find very little of that. I do find an excellent presentation of your own views and recommendations about what the supplemental retirement plan for Federal employees should be.

Now my question. On page 4 of your paper, you say from the standpoint of addressing personnel needs of the Federal Government, a higher retirement age would seem indicated as advantageous to individuals.

How do you rationalize that? How can a higher retirement age be considered advantageous to employees, to individuals?

Mr. Greenough. Your first point is correct, and I believe I made it clear that I was presenting—well, my ideas. In the area of retirement and other benefit plans, I have been a little appalled over the years as to how much we are driven by statistics, especially in Government plans. You go get a lot of statistics as to what everybody is doing, you choose those you want and you go along that particular path, an industry path. I certainly have collected plenty of statistics myself. I think there comes a time when the usefulness of statistics, great as it is, should give way a little bit toward, "when all else fails, think." And I have tried to present to you, since you already have all the statistics and the rest of it, my considered judgment on these matters. If it is out of character with some of the other presentations, so be it, but I certainly have tried to do it without any kidding about what is going on.

Second, the Claude Peppers, the National Association of Retired People, retired teachers, everybody else thinks there is some material advantage in having the ability to continue to work right straight on with no retirement ages. So the possibility of continuing to work on behalf of the individual is a very real American right, or whatever you want to call it.

I can't see why you would even challenge the possibility of that compared with a flat retirement age of 65, nobody can go beyond that, or 60, or whatever.

Mr. Ruddock. Maybe I am getting something out of context, but in the present system, optional retirement on unreduced benefit is available as early as age 55. There is no mandatory retirement age, so it seems to me there is extreme flexibility there, particularly with no mandatory retirement age.

If as a trend, if we raise the age at which people actually retire, then that, of course, is going to be disadvantageous to career employees because their promotional opportunities will be much reduced.

Mr. Greenough. I guess the question is, if I understand it, is it an advantage to say that no more for new Federal employees can you retire at age 55 after 30 years of service with an unreduced, actuarially unreduced, benefit. The new plan will not be that generous, an almost certainty, whether my idea or somebody's else retirement age ideas are there.

The whole point of this—and a lot of the discussion—is that age 55 retirement is much too expensive for the Government and for the taxpayer. Whenever that occurs, then there is political pressure against the system and everything else to do something about it.

I have not been happy with some of the attitudes expressed toward Federal employment, salaries, and the "overly generous Federal benefits." The "overly generous" has to do with retirement at full benefit at age 55 for employees. I suspect that has not served the employees very well.

Mr. Ruddock. Would you consider elimination of that provision as being advantageous to individuals?

Mr. Greenough. Of the age 55?

Mr. Ruddock. Yes.

Mr. **Greenough**. Of course not, no.

Mr. **Ruddock**. We have no problem.

Mr. **Greenough**. I will look at that. Maybe I got that idea in there, but in the total picture, I think getting rid of that age 55 would be good, but I will see if I have stuck it in too much for the individual on that particular narrow point.

Mr. **Shipp**. On that note of agreement, we will break for lunch. We do have a full program for this afternoon. We will begin the afternoon session at 1:30

AFTERNOON SESSION

Mr. **Shipp**. Could I have your attention, please? We are going to begin the afternoon session.

The first presenter, Mr. Robert W. Kalman, will discuss death and disability benefits.

Mr. Kalman is an Associate of William M. Mercer-Meidinger, Inc., an employee benefit and compensation consulting firm. He is located in Washington, D.C.

His areas of specialization include Social Security and employee benefit plan design, with particular concentration on employee benefit plans sponsored by Federal, State and local governments and nonprofit organizations.

Immediately prior to joining Mercer-Meidinger in 1979, Mr. Kalman served for 6½ years with the American Federation of State, County and Municipal Employees as its chief advisor on employee benefit programs. Previously he served as a consultant on health care financing to the National Institute of Mental Health and served on the employee benefit staff of Citibank of New York.

Mr. Kalman has published numerous articles, has testified before many Federal, State, and local governmental bodies, and has been a frequent speaker on employee benefit plans in the public and nonprofit sectors.

Mr. Kalman received his A.B. degree from Franklin and Marshall College, M.S. degree in labor studies from the University of Massachusetts, and postgraduate certificate in health care administration from the George Washington University.

I am very pleased to present Mr. Robert Kalman.

C. Death and Disability Benefits

(Presented by Robert W. Kalman, Associate, William M. Mercer-Meidinger, Inc.)

Mr. KALMAN. As you can tell, I wrote the script.

The subject of my talk is death and disability benefits. Today, I will be talking about the process of designing death and disability benefits rather than concentrating on technicalities. This should give you a flavor for how a benefit consultant usually goes about designing death and disability benefits.

For the most part, I will be staying close to the text of my paper, which the subcommittee staff has distributed.

Currently, the Federal Government provides a substantial part of survivor income protection and all disability protection for Federal employees through the Federal Civil Service Retirement System. By survivor income or death benefits I mean benefits paid to survivors of employees who die during active employment and survivors of retirees. When I refer to disability benefits, I mean permanent and total disability benefits provided through such sources as Social Security, pension plans, and long-term disability income plans.

I am not going to focus on the short-term disability programs that are essential for bridging the gap between the onset of disability and when a person is deemed permanently and totally disabled.

In a 1980 study that my firm completed for New York State, we determined that approximately 80 percent of the value of employee benefits covering Federal employees is provided through the Civil Service Retirement System. This is not unusual in the public sector. Most State and local governments also rely on the pension plan as a major source for nonretirement cash benefits, particularly death and long-term disability benefits.

In the private sector, less emphasis has been placed on the pension plan for providing death and disability income protection. Private employers typically offer substantial death benefit protection to their employees through group term life insurance plans, supplemented by pension plan benefits of one form or another.

Similarly, long-term disability income protection is commonly provided through long-term disability income plans that are established outside of an employer's pension plan. In the public sector, separate LTD plans are rare; disability benefits usually are provided through the employer's pension plan.

In this presentation I will be discussing some of the major factors that the Congress should consider in designing death and disability benefits for Federal employees, that is, the process. This is a complicated area that cannot be dealt with by simply establishing arbitrary levels of benefits.

In my view, the considerations that go into designing death and disability benefits for Federal employees should be no different than the criteria other employers would use in designing thoughtful death and disability benefit programs for their employees. Cost aside, the design of these benefits should be based upon established employer objectives and careful consideration of all possible sources of death and disability income protection.

In the remarks that I will make in the next few minutes, I will be discussing a framework for designing these benefits. Since all of us who do business in Washington have found it necessary to qualify our statements from time to time, I just want to reiterate that this presentation is not intended to be a technical, exhaustive discussion, but more of a very fundamental, probing discussion of this complicated area.

First, I will cover the death benefits area.

The most fundamental step in designing any employee benefit plan is for an employer to identify specific objectives for providing a particular benefit. Some of the questions that should be raised in determining the appropriate design of death benefits are as follows:

First, what is the purpose of providing death benefits to Federal employees? Is it to provide a continuing stream of income for survivors so that they can preserve the level of earnings prior to an employee's death? Is it to provide a lump-sum payment that may tide over the family for a specific period of time? Or is it to provide minimal benefits for burial expenses, funeral expenses, et cetera?

Should benefits be provided to survivors of retirees as well as to survivors of active workers?

Should employees be required to work a minimum period of time in order for survivors to qualify for death benefits? If so, should the service requirement differ for deaths due to occupational and nonoccupational causes?

Who should be considered eligible for these benefits: a surviving spouse, surviving children, surviving parents, or anyone designated by the employee as beneficiary?

Should married and single employees have the same level of benefits available to them?

Can benefits be provided in a more tax-efficient manner in one form than in another?

Should benefits be designed to dovetail other sources of employer-provided death benefits, including those payable under Social Security and workers' compensation?

What can be learned from the current design of death benefits for Federal employees? Are there any gaps or duplications in current benefits? Are all groups of employees being covered equally, and by that I mean single and married, young, middle-aged and older employees?

These are only a few of the key questions that need to be raised in setting objectives for the design of death benefits. They address benefit levels, benefit eligibility, equity in entitlement to benefits, and tax treatment of benefits. I will cover each of these areas as I review the three major sources of survivor insurance protection: Social Security, pension plans, and group term life insurance plans.

The first source is Social Security. One of the reasons we are here today is because, effective January 1, 1984, all new employees of the Federal Government are covered under Social Security on a mandatory basis. In 1984, covered employees pay a Social Security tax of 6.7 percent of their salaries up to $37,800 a year. The Federal Government and other employers participating in Social Security pay 7 percent of an employee's salary up to $37,800. In future years, taxes for employees and employers will rise in accordance with the schedule established by the Social Security Amendments Act of 1983, unless Congress decides otherwise.

Social Security survivor benefits are important and should be considered the basic level of death benefit protection for Federal employees. All other death benefits offered to Federal employees through a pension plan, life insurance or any other arrangement should be considered supplemental to Social Security survivor benefits.

There are several types of benefits that may be payable under Social Security when a covered worker dies. My written presentation reviews different coverage requirements that must be met for survivors to qualify for benefits. I will not take the time now to discuss the details. I would rather go on to a discussion of the various types of survivor benefits available under Social Security.

In addition to the lump-sum $255 benefit payable to a surviving spouse, monthly Social Security survivor benefits can be paid under a variety of circumstances. For example, benefits can be payable to a spouse caring for an eligible child; a divorced spouse caring for an eligible child; an eligible child; a spouse age 60 or older—50 or older, if completely disabled; a divorced wife age 60 or older--50 or older if completely disabled—if the marriage lasted at least 10 years; or dependent parents aged 62 or older.

Benefits are tax-free, except for survivors who have substantial incomes.

The value of death benefits provided by Social Security is not generally recognized by the public. The value of Social Security survivor benefits can range from $255 to $200,000 or more, depending upon individual circumstances. Several examples I have presented in my paper are shown in a table from Haeworth Robertson's book, "The Coming Revolution in Social Security." The table shows estimates of monthly Social Security death benefits and the actuarial present value of future benefits to survivors of workers dying in January 1980 in selected situations. While the dollar amounts shown here have changed somewhat since these examples were developed, the levels of income replacement have remained approximately the same.

As this table illustrates, Social Security can be a significant source of death benefits for workers in covered employment, a source that the Federal Government should consider carefully in determining the appropriate design of supplemental survivor benefits for Federal employees who are covered by Social Security.

The second major source of death benefit protection is through pension plans. Generally, public and private pension plans provide survivors who meet certain eligibility requirements with some form of death benefit. In the private sector, benefits are limited by IRS plan qualification requirements; the level of death benefits must be incidental to the primary purpose of the pension plan, which is to provide post-retirement income to plan participants. Technically, this limitation applies to public plans as well, at least at the State and local level, but this and other plan qualification requirements have not been enforced in the public sector.

ERISA also sets specific requirements that qualified private pension plans must meet in providing death benefits. First, if the plan offers an early retirement benefit, it must give plan participants the opportunity to elect an early survivor annuity. This benefit would be payable to a surviving spouse if the worker dies after reaching early retirement age but before reaching actual retirement. The benefit must equal at least one-half of the worker's accrued benefit at the time of death. ERISA also requires that pension benefits for married employees must be paid as a qualified joint and survivor annuity unless the employee elects to receive the retirement benefit in another form. The joint and survivor annuity gives a retired worker a pension benefit which would be continued at the same amount or at a lower amount to the retiree's surviving spouse. In a contributory pension plan, ERISA also requires that the employee's beneficiary receive a refund of employee contributions plus interest thereon that has not been paid out in pension plan benefits.

Even though these ERISA requirements do not apply to Federal pension plans, in my view Congress should consider the appropriateness of incorporating them into a newly designed Civil Service Retirement System.

Preretirement death benefits that are offered by pension plans include the following:

First, monthly pension equal to a percentage of what the deceased employee would have received had that person retired on the date of death.

Second, lump-sum payment based on the value of the deceased employee's accrued pension up to the date of death.

Third, lump-sum payment based on the value of the projected benefit that would have been earned had the deceased worker continued working until normal retirement age.

Fourth, lump-sum payment—through a group life insurance program—up to 100 times the expected monthly pension benefit that the deceased employee would have received had that person reached normal retirement age.

And last, lump-sum payment that is designed to meet "final" expenses of the deceased worker—burial, funeral expenses, et cetera.

For post-retirement death, a pension plan usually gives participants the opportunity to choose among several survivor options—in addition to the survivor option required by ERISA. The plan may also offer survivors a small lump-sum payment.

It is important to recognize that the various forms of death benefits provided through a pension plan are not necessarily available to all survivors. Some pension plans specifically require that the beneficiary be a surviving spouse or perhaps a surviving child. This requirement could exclude survivors of single employees from qualifying for a death benefit through a pension plan. Other limitations on survivor benefits also exist.

Monthly survivor benefits are taxed as ordinary income, after the retiree recovers the value of any employee contributions that were made. Lump-sum payments also are generally taxed as ordinary income, although they may be eligible for favorable 10-year forward averaging—designed to lower the tax rate on the distribution. The first $5,000 of a lump-sum payment is exempt from Federal taxation.

The third source of death benefit protection is group term life insurance. Employer-sponsored group term life insurance plans provide valuable protection for employees and their families. For white-collar workers, benefits usually are a multiple of a person's annual base salary. In the private sector, the typical range of coverage is between one and two times annual base salary for full-time employees. In large corporations, this basic level of life insurance coverage usually is noncontributory.

A life insurance plan almost always has an accidental death and dismemberment provision as well, which provides additional benefits in case of accidental death. Some employers continue life insurance coverage after retirement at reduced levels, while others terminate coverage when an employee retires.

An employee has the latitude of naming any beneficiary desired, or else the payment is made to the person's estate. As I noted earlier, pension plans may allow employees less flexibility in designating a beneficiary and, thus, may exclude certain classes of employees altogether from employer-provided death benefit protection. Many employers cover all active employees under their life insurance plans from the date of hire or after a short waiting period. This gives employees of all ages, regardless of marital status, a basic source of death benefit protection.

While survivor distributions from pension plans are taxed as ordinary income, group term life insurance payments are tax-free to the designated beneficiary, although subject to tax on the deceased person's gross estate. It is a very tax-efficient form of providing death benefits.

In summary, I have identified three major sources of survivor income that are available in the public and private sectors. Social Security can provide substantial survivor income to individuals, depending upon specific circumstances, or it can provide virtually nothing. In designing survivor benefits for Federal employees, Congress should recognize the possible range of death benefits that may be payable under Social Security.

Employer-sponsored pension plans and life insurance plans can provide valuable death benefit protection for employees that supplements basic Social Security benefits. Each plan has advantages and disadvantages which decisionmakers should understand. Particular attention should be given to the needs of employees in different age groups, the availability of benefits to married, single, young, and older employees, the level of benefits offered to survivors under different circumstances, and the tax treatment of pension and life insurance benefits.

Unless care is taken in designing survivor benefits, employees who have the greatest need for this protection may find that they have the least adequate coverage, while other employees, who have a lesser need for death benefit protection, may have the best protection.

A suggested plan of action for designing Federal employee survivor income benefits would be:

First, establish objectives that meet both the needs of the Federal Government and the needs of Federal employees.

Second, establish Social Security as the basic level of death benefit protection.

Third, design supplemental benefits, utilizing the best features of pension and group term life insurance plans, and other available sources of survivor income.

Now I will turn to long-term disability.

The financial impact of permanent and total disability on employees and their families can be devastating if there is no disability income protection. The results can be more severe than the death of an employee, yet protection against income loss arising from disability generally has not been given high priority.

As with my discussion of death benefits, I will begin by talking about the importance of objective setting in designing disability benefits. Then I will discuss major sources of benefits.

The fundamental design of long-term disability benefits depends upon the employer's objectives for offering this protection. Here are some of the basic questions that I believe the Congress needs to ask in contemplating what would be an appropriate design of disability benefits for Federal employees.

First, what level of disability income protection should be provided to employees? What is adequate?

Would any groups of Federal employees still be exposed to the risk of substantial income loss by choosing one form of disability income protection over another?

What definition of long-term disability should be used?

Who should be eligible for this protection?

Should there be a waiting period for new employees?

What is the most efficient and effective means of providing LTD benefits?

Finally, in reviewing existing LTD protection for Federal employees, which is made available through the Civil Service Retirement System, what gaps and duplications in benefits exist?

There are three major sources of disability income protection: Social Security, pension plans, and long-term disability income plans.

Social Security disability benefits are payable only if a covered employee is so severely disabled that the person cannot perform any substantial gainful work and the disability is expected to last at least 12 months or result in death. Furthermore, a person must have been disabled for 5 full consecutive months in order to begin receiving benefits. And last, disability benefits will be payable only if the person has paid Social Security taxes for a specified number of quarters, which would vary based upon a person's date of birth and date of disability.

Because of Social Security's stringent eligibility requirements, many disabled employees do not qualify for these benefits. If these eligibility requirements are met, there is no guarantee that Social Security disability benefits will be adequate. Benefit levels depend upon a person's covered earnings, number of family dependents, and to some extent the age when a person becomes disabled.

I have included in my written remarks another table from Haeworth Robertson's book that looks at the varying levels of disability income protection for covered employees. It is based upon 1980 data, but the levels that are contained in this table are approximately the same as what would be offered under similar circumstances today. So in reviewing this data, note the variation in Social Security disability benefit levels for each level of earnings shown.

Social Security disability benefits can provide almost full replacement of lost income for people in lower salary brackets and replace relatively little for those in the upper brackets. The challenge to employers is to design an LTD program that supplements Social Security benefits and provides appropriate income replacement to employees at each salary level.

Employers sometimes choose to provide employees with disability income protection through their pension plans. This can be accomplished in several ways. For example, the disability benefit may be established as a fixed percentage of the person's base compensation as of the date of disability, a percentage of the person's accrued pension benefit, or a percentage of the person's pension benefit projected to normal retirement age.

Disability benefits typically are paid on a monthly basis until the employee reaches normal retirement age, unless the person recovers. Upon reaching retirement age, the disabled employee may be reclassified as a retiree. He then might become entitled to a pension benefit based upon compensation at the time of disability and service projected from the date of disability up to normal retirement age. When disability occurs after reaching early retirement age, the disabled employee may begin receiving regular early retirement benefits instead of disability benefits.

Typically, employees must meet a length-of-service requirement under the employer's pension plan to qualify for disability benefits. The service requirement may be 5 years, which is a common requirement in the public sector, 10 years, and sometimes 15 years or longer. FCSRS currently requires 5 years in order to qualify for disability benefits. This means that employees who do not meet the pension plan's length-of-service requirement would not have any disability income protection unless they were participating in a separate LTD plan. The most vulnerable employees are young, short-service workers with growing family responsibilities.

All disability benefits are taxed as ordinary income unless a disabled employee becomes eligible for the tax credit for the elderly and disabled.

Many private employers provide their employees with disability income protection through self-standing long-term disability income plans. These plans may be insured or self-insured.

Generally, coverage is available to all full-time employees as of the date of hire or after a short waiting period. These plans provide disability income protection equal to a percentage of an employee's base salary at the time of disability, usually ranging between 50 percent and 66⅔ percent of salary. Benefits ordinarily commence 3 to 6 months after the onset of disability if other plan requirements have been met. Benefits are typically offset by Social Security and other sources of disability income.

One of the principal advantages of providing disability income protection through a separate LTD plan is flexibility in meeting employer and employee needs. For example, there is ease in coordinating benefits with Social Security and other sources of disability income without being concerned about meeting IRS integration rules that apply to pension plans.

Furthermore, and I think this is extremely important, all covered employees can be offered the same level of disability income protection, regardless of length of service with the employer. Short-service employees would receive the same level of disability benefits as career employees.

When a separate LTD plan is offered, a well-designed pension plan ordinarily would not offer additional disability benefits. Instead, it might grant disabled employees credited service from the date of disability up to normal retirement age, when LTD plan benefits usually cease. The disabled employee would then be reclassified as a retiree and his pension, under a defined benefit plan, would be based on salary at the time of disability, years of credited service up to the date of disability, and projected service from the onset of disability to normal retirement age.

The tax treatment of disability income benefits payable from an LTD plan and a pension plan is the same. The entire amount is taxed as ordinary income unless a disabled employee qualifies for the tax credit available to the elderly and disabled.

To summarize, I believe the process of designing death and disability benefits for Federal employees should be no different than the process used by other major employers in designing benefits for their employees. The first step is to set forth specific objectives that meet both employee and employer needs. Then it is essential that all available sources of death and disability benefits be understood and evaluated carefully. Social Security should be established as the basic level of death and disability income protection. Employer-provided death and disability benefits should be designed to supplement Social Security benefits. Flexibility, tax treatment of benefits, and equity across different employee groups are just a few of the factors that should be considered in determining the most appropriate design of supplemental death and disability benefits for Federal employees. In my opinion, the key to success will be prudent and thoughtful planning.

Thank you very much.

Mr. SHIPP. Questions for Mr. Kalman. Yes?

Mr. DUBRIN. Bob, in your concluding comments, you made the statement that an appropriate salary for the regular benefit, retirement benefit, would be the salary at the time of disability. Would that be realistic? If I understood you correctly, would that be a realistic basis?

Mr. KALMAN. Would you please repeat the question?

Mr. DUBRIN. If I understood your comment, you said when a person reaches a certain age, they would become eligible for the normal retirement benefit and that the salary in determining that benefit would be the salary at the time of the disability.

Mr. KALMAN. What I said was that if a person is receiving a disability benefit from a separate LTD plan, the pension plan probably would provide the disabled person with a pension upon reaching normal retirement age. The pension would be based upon the person's final average salary at the time of disability, years of credited service while disabled as well as years of service during active employment.

Mr. DuBrin. I see.

Mr. Kalman. I was not suggesting that a disabled employee would receive a pension plus LTD benefits at the same time.

Mr. DuBrin. Because otherwise it might result in a rather severe reduction in benefit.

Mr. Kalman. Right.

Mr. DuBrin. OK.

Mr. Shipp. Are there other questions? Tom?

Mr. Eickmeyer. In the design with the LTD, I think generally they are not cost-of-living indexed. The benefits are usually offset by the Social Security and other types of benefits being received.

Mr. Kalman. That is correct.

Mr. Eickmeyer. Which are indexed and can eventually come up to or exceed the LTD benefit, therefore wiping that benefit out. How, in designing a program around the separate LTD, do you avoid being wiped out by inflation?

Mr. Kalman. By inflation? Well, that is a very difficult issue for which I don't have an answer. I have never seen an LTD plan that provided an automatic cost-of-living adjustment. But then again, I have seen very few pension plans that have provided full cost-of-living adjustments.

If there was rampant inflation and someone was disabled at a very young age, the LTD benefit—other than Social Security disability benefits—would be eroded by inflation. The cost of providing automatic adjustments in benefits for inflation would be prohibitive.

I would like to note that it is not just important to look at what is ideal for employees; I think what is also important is to consider the cost of providing the benefit. I think it is very important, whether you are dealing with disability, death, retirement benefits, to provide appropriate benefits to employees, but if the other side of the equation, cost, is not considered in the process, employers would be making an uninformed decision.

This morning Hastings was agonizing over the cost of the Federal Civil Service Retirement System. I don't know if his figures are correct, but his concern over the cost of Federal benefits should not be overlooked. In determining what would be an appropriate benefit for Federal employees in the disability area, cost is a very important factor to consider.

Mr. Shipp. Yes?

Ms. Benson. I really have a comment. Mr. Kalman, you brought up an interesting point, that the Civil Service Retirement System includes nonretirement benefits, such as long-term disability, whereas in the private sector these nonretirement benefits are usually provided through separate plans.

In the earlier forums there was a lot of discussion about comparing the cost of private sector retirement plans with the Civil Service retirement plan and a lot of discussion as to why this is comparing apples and oranges and involves fallacious comparisons, et cetera.

This point, that the CSRS includes nonretirement benefits, is just one more additional reason why you cannot compare the Civil

Service retirement plan with simply the retirement plan alone provided in the private sector.

Mr. Kalman. First, what I said was that, in the public sector, death and disability benefits are primarily provided through a pension plan. In the private sector less emphasis is placed on the retirement plan for providing these benefits.

Second, you have a very good point about comparing Federal and private sector benefits. In my opinion, benefits should not be compared on a plan-by-plan basis. I believe the most valid comparisons are based on total benefit comparability.

Mr. Shipp. We have a question over there, and then one back here.

Mr. Cowles. George Cowles, the Bankers Trust Co.

I think there is a misconception on the table based on Mr. Eickmeyer's question, Bob. I think you didn't respond to part of the question.

Mr. Kalman. Please explain.

Mr. Cowles. The implication in his question was that the long-term disability benefit would be reduced as the Social Security benefit was increased, which in fact is not the case. Once the LTD benefit has been determined, it remains constant and cannot be reduced as a result of future increases in Social Security.

Mr. Kalman. I didn't interpret Mr. Eickmeyer's question that way. If he meant what you said, I agree with your answer. Just as in an integrated pension plan, where a pension benefit would not be reduced beyond retirement, once disability benefits under a self-standing LTD plan are integrated with Social Security, a disabled employee's LTD benefits are not reduced further if Social Security benefits are increased subsequently because of inflation.

Mr. Shipp. Other questions? Yes?

Mr. Bittkau. Manfred Bittkau, UAW.

Basically I wanted to make the same comment. In plans that we have negotiated, which are flat dollar amounts for years of service, as negotiations go on and benefits are increased and where the pension plans are integrated with the LTD, there is also no offset for those increased pensions. Let's say the man starts with a $10 benefit which is offset with the LTD. During negotiations, as time goes on, it goes to $12. The level of offset remains at $10. This is an improvement he enjoys, even though the majority of his income in fact comes from the LTD.

Mr. Kalman. Yes.

Mr. Bittkau. The other point that I think has not been raised here is what are we talking about. When we get to disability particularly, is it family benefits or primary benefits? Usually it is our position that the primary benefit is really the only benefit that should be offset. This applies equally in the case of death when there are transition and bridge payments payable subsequent to death.

Mr. Kalman. I don't think there is any set answer to that. My personal view is that the offset should be based on primary Social Security benefits.

Mr. Shipp. A question here?

Mr. Zimpleman. Larry Zimpleman, American Academy of Actuaries.

Two points. First of all, would it be fair to say that your discussion in the paper of pension plan benefits relates primarily to defined benefit plans?

Mr. KALMAN. Yes.

Mr. ZIMPLEMAN. There is not necessarily the range of options available for defined contribution plans. That is important because there has been discussion of supplemental plans throughout the day.

Mr. KALMAN. For the most part, I have limited my discussion to defined benefit plans.

Mr. ZIMPLEMAN. Just for clarification.

Mr. KALMAN. Thank you.

Mr. ZIMPLEMAN. The second point, would you have any comments at all, Bob, about what I guess I might call the current mood of Congress relative to survivor benefits inside qualified pension plans as manifested by some of the recent equity legislation and the extension of survivor benefits down towards age 45, for example, rather than an early retirement age?

Mr. KALMAN. I prefer not to comment on this issue at the present time.

Mr. SHIPP. Jamie?

Mr. COWEN. Bob, you made a point in your paper of saying that disability under Social Security was very stringent and difficult to obtain. Does that lead us to believe that in the private plans the disability eligibility is far easier to obtain?

Mr. KALMAN. No, not necessarily. Definitions of disability can vary from one plan to the next, although in the private sector disability tends to be defined more stringently than in the public sector.

Mr. COWLES. A follow-up then. Do firms treat disabled employees differently depending upon whether they meet Social Security disability requirements?

Mr. KALMAN. Some private sector LTD plans require that a person qualifying for Social Security disability benefits become eligible for plan benefits. More typically, however, LTD plans have less stringent definitions of disability than Social Security, particularly during the first 2 years of disablement.

Mr. SHIPP. Yes?

Mr. SHANEFELTER. One thing you didn't mention in your paper and I would like to get your opinion on.

Mr. KALMAN. Only one?

Mr. SHANEFELTER. At least one. That is administration of the program.

Are you suggesting that for the new retirement system the Federal Government contract with an insurance firm for an LTD plan, or are you suggesting it should be self-insured? In any event, should it be administered by OPM or should it be administered by an independent body?

Mr. KALMAN. I haven't really thought about who should administer the program. I think that battle can be decided by Congress and other appropriate parties of interest. At this time, I am not sure what would be the best course of action to take for administering a disability program for Federal employees.

As for plan design, my bias is that long-term disability benefits should be provided outside of the Civil Service Retirement System. In a huge group like the Federal work force, I believe these benefits should be offered through a self-standing plan that is financed on a self-insured basis.

I would like to make one more point. In the case of the Federal Civil Service Retirement System, or any other retirement system that is the sole source of employer-provided disability benefits, we find that short-service employees are not protected. This group usually is made up of young people who have growing family responsibilities and need disability protection the most. Yet, these employees usually receive little or no protection through the pension plan early on in their careers with an employer.

Mr. SHIPP. We are going to take three more questions here. Andy and then Jim.

Mr. RUDDOCK. On page 3 you asked the question:

> Should employees be required to work a minimum period of time in order for survivors to qualify for death benefits? If so, should the service requirement differ for deaths due to occupational and nonoccupational causes?

I think we should all be aware that the Government has in place a workmen's compensation system under which both survivor benefits and also disability income are paid for occupational disease or injury, and that is a factor that will need to be considered in the development of a supplemental retirement plan.

My question is on page 9. You indicate that some of the death benefits offered by pension plans include the following: Monthly pension equal to what the deceased employee would have received had that person retired on the date of death.

Would it not be more typical that the monthly pension be equal to a fraction of what the deceased employee would have received had that person retired on the date of death? A fraction rather than equal to.

Mr. KALMAN. I think you may be right in particular cases. Let's say I am 55 years old on the date of death. I am an active employee. I have 30 years of service with the Federal Government. What are you saying should be my survivor or death benefits in that case? I am trying to understand the question.

Mr. RUDDOCK. Let's start with what the benefit is. The benefit is 55 percent of the annuity that would have been payable to the employee if he or she had retired on that date.

Mr. KALMAN. Right.

Mr. RUDDOCK. I am asking is it not more typical that that survivor benefit be a percentage?

Mr. KALMAN. In the Federal Government it is a percentage of what the retirement benefit would be on the date of death.

Mr. RUDDOCK. Does that differ in private industry plans?

Mr. KALMAN. No.

Mr. RUDDOCK. I am looking for information. This isn't a challenge.

Mr. KALMAN. I understand. Your point is well taken. In my paper the statement that you quoted should have read, "monthly pension equal to 'a percentage of' what the deceased employee would have received had that person retired on the date of death." I will make this change in my written statement. Thank you.

Mr. RUDDOCK. Thank you.

Mr. SHIPP. Yes?

Mr. BITTKAU. You raised the question whether people are treated differently when they retire on disability compared to normal retirement. Quite often there is in fact a supplement payable for early retirement as a result of disability which is subject to offset, and that is the only piece subject to offset by Social Security. So if you don't get Social Security, you have a supplement coming from the pension plan. In the event you are getting Social Security, the pension is being reduced. Another comment relative to the disability requirements: You will find in many bargained, negotiated plans the conditions for eligibility for disability are "unable to work in the plant where the person has seniority." So basically it means that if there is no job for him to be found where he can be put to work in that company, that this would generally satisfy the disability requirement.

Mr. KALMAN. In many LTD plans, the definition of disability is less restrictive during the first 2 years of disablement than thereafter.

Mr. BITTKAU. Yes. But generally under short-term disability provisions eligibility for benefits extends to one who is unable to do one's work for typically a year or two. But the LTD or extended disability benefits generally have a more restrictive definition such as unable to work for the company.

Mr. KALMAN. OK.

Mr. SHIPP. We have time for one more question. Jim?

Mr. STOREY. Bob, could you spell out a little bit more what you see as the key factors that are involved in choosing to go with group life insurance versus pension plan benefits for survivor protection for the younger employee?

Mr. KALMAN. All right.

Mr. STOREY. And how does that relate to the Federal Government situation?

Mr. KALMAN. I think an augmented life insurance program for Federal employees would be very helpful in providing death benefit protection, particularly for younger employees. I believe that it is not a tradeoff between pension and life insurance benefits. I think it is a blending of the two types of survivor benefits in meeting employee needs.

Mr. SHIPP. Thank you very much.

The next scheduled speaker was Eugene Kalwarski, who was going to treat the subject of vesting and the employee. Mr. Kalwarski is not able to be here today, so we will move to the last speaker, Dale Grant.

Before I introduce Mrs. Grant, I would like to point out that on the back table are copies of the committee print on the proceedings and papers of the second one of these policy forums. I understand there are plenty of copies for everybody so you don't have to get up and get one right now. Pick one up on your way out.

Dale Grant is going to talk about cost-of-living adjustments. She is a Senior Vice President and Actuary with Martin E. Segal Co., an employee benefits consulting firm. She is director of the company's actuarial managers committee, which sets policy on actuarial matters nationally. She is also responsible for company training and education of actuarial managers. Mrs. Grant has been a benefits consultant to a number of clients over the past 20 years. She is on the Technical Advisory Committee of the Employers Council on Flexible Compensation and has served on a variety of other professional and educational committees. She is a Fellow of the Society of Actuaries, an Enrolled Actuary, a member of the American Academy of Actuaries and the International Actuarial Association.

I am very pleased to introduce Mrs. Dale Grant.

D. Cost-of-Living Adjustments

(Presented by Dale B. Grant, Senior Vice President and Actuary, Martin E. Segal Co.)

Mrs. **Grant**. I can't restrain myself from commenting on the fact that whenever I share the panel with an otherwise all-male group, I am the last speaker. I consider that as a vote of confidence in women.

From the Floor. They save the best until last.

Mrs. **Grant**. Yes.

The first thing I want to do is change the title of this discussion from cost-of-living adjustments to post-retirement adjustments because post-retirement adjustments aren't necessarily related to the cost of living.

Why are we discussing post-retirement adjustments? The reason is that with inflation at the rates we experienced in the recent past, a fixed income is eroded by more than 50 percent in just a few years, and the period of retirement extends a great deal beyond a few years. People are living longer. On average, they live to over 80. People are retiring earlier. They are retiring in their early sixties. So that means that the average period of retirement is now about 20 or 25 years. That is a long period of time to have to deal with inflation on a fixed income.

When we deal with post-retirement adjustments, there are two issues to consider. First, what formula should be used for adjusting pensions after retirement? Second, once the formula has been determined, how to deliver the benefit that has been decided on.

First for the formula. Some people say you don't need a formula; you just automatically adjust pensions to the CPI like Social Security. Well, that is not generally the practice. Usually there is a formula for adjusting pensions in retirement. There is a whole variety of approaches that could be used. It is almost like designing a basic retirement program. The typical approaches are, one, to use some percentage of the CPI, either 100 percent of the CPI or something less, like 70 or 80 percent of the CPI. Another is to use a fixed annual adjustment, either a fixed percentage, like 3 percent per year, regardless of inflation, or a fixed dollar amount, like $10 per month per year, regardless of inflation.

Now, the problem with that approach is that in periods of high inflation, the adjustments aren't generally enough. In periods of no inflation, if we ever see those periods again, the adjustments are made even when they are not needed.

There is another approach called catastrophic protection. In catastrophic protection, pensions are adjusted by the rate of inflation less some fixed percentage, so it might be the CPI less 3 percent or less 5 percent, on the grounds that the employee can absorb the first few percentages of inflation.

Now, that might work during periods of sporadic high inflation, but it doesn't work very well when you have moderate inflation for an extended period because the post-retirement supplement never kicks in while there is a constant erosion of the benefit during the period of retirement.

Another approach is to provide post-retirement supplements out of excess investment earnings. That could be done either in the defined contribution plan or defined benefit plan. If the defined benefit plan is valued at some conservative interest rate, or even a realistic interest rate, during periods of high inflation, you would expect excess investment earnings to be high and those earnings can support it. If you are using a defined contribution approach, the post-retirement supplement can be the amount that the defined contribution account can provide.

Of course, there is a variety of combinations of things you can use. Typically, if you have some percentage of the CPI approach, you would cap the amount of the adjustment, say, if it is 80 percent of the CPI, to a maximum of 5 or 6 percent, or to a fixed dollar maximum.

In the private sector, when the percentage of the CPI approach is used, it is most often applied to, say, only the first $20,000 of benefit or first $10,000 of benefit.

In addition to the basic formulas that can be used for providing post-retirement supplements, there are other things that sometimes people tend to forget about that have to be considered in the context of adjustments. One of them is who should the post-retirement supplements be given to? Should they be given to all retirees, vested terminations and those who have spent a full career with the company, or just the employees who retire on early retirement or normal retirement. Should just normal and early retirees get the supplement and not the vested terminations? There is some question about the legality of excluding vested terminations from the post-retirement supplements. But if the post-retirement supplements are made outside of the pension plan, then you can discriminate against them.

Should spouses be considered? If your plan provides a spouse's benefit as part of the regular benefit formula, should the post-retirement adjustments be given to beneficiaries as well as spouses?

Finally, and this is an important one, what age should the post-retirement supplement begin? Should it begin at early retirement or should the dollars available for post-retirement supplements be focused on age 65 and beyond?

Those are all questions that have to be considered in the design of a post-retirement supplements formula.

There are other related issues in deciding the amount of the supplement. First of all, adequacy at the point of retirement. If for some reason, whatever reason, benefits at the point of retirement are above what you would consider a reasonable retirement income objective—maybe there is a capital accumulation plan, and there are more dollars available than the original objective—then the need for post-retirement supplements is not as great. A certain amount of inflation protection is built into the initial benefit formula. If on the other hand the benefit at retirement is lower than you consider to be an adequate retirement income, then the need for post-retirement supplements becomes even more important.

Another question is whose responsibility is it to protect employees for lost purchasing power? Is it fully an employer's responsibility or should employees share in the costs of replacing lost purchasing power, either through reduced expenditures or through their own personal savings?

It has been the tendency to reflect an employee's sharing in the effects of lost purchasing power in the benefits that have been provided on post-retirement in the past. Typically, a large private sector employer will replace 70 or 80 percent of lost purchasing power. If 70 to 80 percent of lost purchasing power is to be replaced, then the role of Social Security becomes very important and has to be taken into account. Social Security is fully indexed. If we are talking about purchasing power, we are talking about total retirement income. If an employee is receiving half of his or her total retirement income from Social Security, then purchasing power is replaced 50 percent by Social Security alone. If the objective is to provide 75 percent of total lost purchasing power, then the retirement plan needs only to provide an adjustment equal to 50 percent of the CPI. The retirement plan provides 50 percent of the CPI, Social Security provides 100 percent of the CPI. So on average, if you add them together, that is a replacement of 75 percent of the CPI. So the role of Social Security is important.

What is the prevailing practice? I mentioned the fact that private employers typically replace 70 to 80 percent. It is probably a broader spectrum than that, actually—50 to 80 percent of lost purchasing power or 50 to 80 percent of the CPI.

In negotiated plans, often the pension is adjusted as a result of excess investment earnings due to inflationary investment returns.

In the public sector, there is a much broader spectrum of approaches. Many plans in the public sector used to, and there are still quite a few, provide automatic adjustments equal to the CPI. Public plans are trying to get away from that approach. But a number of public plans did provide and continue to provide some fixed percentage increase per year, automatically, as part of the plan, like 3 or 4 percent.

The excess investment earnings approach also is used, and usually there is a combination of these approaches—a fixed percentage per year, some supplemental adjustment equal to some percentage of the CPI, and also using some excess investment earnings.

Now once having determined a benefit formula, let's talk about the delivery of the benefits. When we talk about post-retirement supplements, we have commonly a different approach than is used for basic retirement benefits. For basic retirement benefits, we usually consider defined benefits, defined contributions, or some combination of them. For post-retirement supplements, the additional alternative is to make ad hoc adjustments. Ad hoc adjustments are adjustments that are made without any express, legally binding, contractual obligation to make them. There is no plan provision anywhere that says that an employee will get a certain post-retirement adjustment. Instead, employers or plan sponsors review their benefits from time to time and decide, on an ad hoc basis, whether they should give an increase and how much the increase should be.

From an employee's perspective, the ad hoc approach has no guarantees, and they certainly have no certainty that their benefit needs will be met. From the employer's perspective, the ad hoc approach has several apparent advantages.

First, since there is no commitment, the employer or plan sponsor can decide—based on its own financial considerations, and other needs—whether to give a benefit increase and when to give the benefit increase. It can tell precisely what the cost of the benefit increase will be. There is no commitment for benefit increases in the future. The employer gets credit for each benefit increase as a benefit improvement.

Now let's go over all of these advantages again, because I said they were apparent advantages. If we look more closely, the advantages are to a large extent illusory.

First of all, no commitment. Well, if an employer has made post-retirement adjustments routinely over a period of years, there is an implied commitment, and employees will generally expect those retirement increases to continue. While it may not be a legal, contractual, binding commitment, there is certainly a level of expectation among employees. Rather than view each additional increase as a benefit improvement, employees will view the lack of a benefit improvement or a lack of a benefit increase with dissatisfaction. They expected the benefit increase.

In terms of cost, if you have already set up a pattern of making adjustments, and an employer focuses only on the cost of the specific adjustment being made at that point in time, then the hidden cost of all of the future adjustments that will really have to be made, because there is an implied commitment, is lost. That reduces prudence in designing post-retirement adjustments.

Now, despite all of these disadvantages, the ad hoc approach is the one used almost universally. It is used predominantly in the private sector, and it is becoming more and more popular in the public sector. Basically, all of these other things aside, it is really a question of cost. I will get to that in a minute.

Using a defined benefit approach to deliver post-retirement adjustments. A defined benefit approach would be one where there is an express, legal, contractual commitment to provide adjustments on the basis of a specified formula at specified intervals. It is usually part of the pension plan.

Now, that formal commitment is both the advantage and the disadvantage of a defined benefit approach. The advantage is, of course, that the employee knows what to expect and can plan accordingly. The employer can identify its ultimate cost and can plan its financial commitments accordingly.

But that commitment is one that the employer cannot really get out of, especially in the public sector. And the commitment to continue to provide post-retirement increases, regardless of what the employer's ultimate financial position is going to be, has been a burden.

The cost of post-retirement adjustments—and, as I said, in a defined benefit plan, the cost of not only the current adjustments but all future adjustments—is right up there before you. It is wrapped up as part of the whole cost of the pension plan. As a rule of thumb, each 1 percent adjustment after retirement adds 10 percent to the cost of the defined benefit plan. So a 3-percent adjustment, not a staggeringly large adjustment, adds 30 percent to the cost of the plan. A 6-percent adjustment adds 60 percent to the cost of the plan.

Now we have some idea why employers shun the idea of making a defined benefit commitment for providing post-retirement adjustments. It is not that providing post-retirement adjustments to a defined benefit plan is in fact more expensive than providing them on an ad hoc basis. The cost of the benefit is the cost of the benefit no matter how you provide it. It is just that the cost is there and in front of you and has to be faced currently.

The defined contribution approach. The defined contribution approach can be used to provide post-retirement supplements in two ways. One is part of the basic retirement program. If the basic retirement program is designed as a defined contribution program, then the benefit at the point of retirement can be converted to an annuity at a conservative interest rate, and then the excess earnings, during the period of retirement, can be used to provide post-retirement supplements. So, for example, the accumulation at the point of retirement can be converted to an annuity on the basis of, say, 3 percent interest. Then investment earnings that will accumulate on that sum after retirement in excess of 3 percent go to provide post-retirement supplements.

The other approach is to have a separately defined post-retirement supplement contribution account. That account could be used solely to provide post-retirement adjustments. At retirement, the amount in the account is converted to an increasing annuity, an increasing stream of payments that are compared to whatever the basic form of retirement benefit is.

That has several advantages. First of all, savings account approaches are popular anyway with employees. They see an account balance. It is available for other things, like death and disability. It is a way to get employees involved in saving for post-retirement supplements.

If the approach taken in the defined contribution plan is a thrift plan approach, where the employer matches a certain employee contribution, then employees and employers share in the cost and responsibility for making post-retirement adjustments. The employer has a fixed commitment. The employer knows that its contribution to provide post-retirement supplements is not some staggeringly large number but some fixed percentage of pay or dollar amount that goes into the savings plan.

The disadvantage, as with any defined contribution approach, is that you can't have a target, you can't have a benefit target. Your benefit is whatever the defined contribution account provides.

In the short term, defined contributions aren't going to provide anything because the accumulation is going to be too small. But even in the long term, if the investment earnings that were expected don't materialize, or inflation during the period of retirement is higher than was planned for and designed in the defined contribution approach, then the employees are going to have inadequate post-retirement income.

Of course, there are the other related problems of defined contribution plans, like additional recordkeeping and administration.

Now, we talked about the disadvantages of several approaches. One way to deal with the disadvantages is to pick up the good points of all of these approaches: the defined benefit approach, the defined contribution approach, and the ad hoc approach. That combination of approaches might work as follows.

The basic retirement plan and a post-retirement supplement defined contribution plan. Employees and employers or employers alone contribute to the defined contribution plan. Let's say for the sake of argument that the plan calls for a 3-percent employee and a 3-percent employer contribution. That account is kept separately for post-retirement supplements.

In the meantime, at the same time, you have a defined benefit plan that guarantees a floor of protection, a floor adjustment, so that at the point of retirement, the defined contribution plan is converted to an increasing annuity, and if it doesn't meet the floor of protection, the defined benefit plan kicks in the difference. So if the defined benefit plan, say, guarantees at least a 4-percent adjustment, and the defined contribution plan can only provide a 3-percent adjustment, the defined benefit plan would pay the additional 1 percent. So that in combination the defined contribution plan and the defined benefit plan make up the package.

Now, if a 4-percent adjustment is not high enough during periods of very rapid inflation, then the ad hoc approach can be used to supplement these two plans.

Thank you.

Mr. SHIPP. Thank you.

Questions? Mr. Keith?

Mr. KEITH. I come from Massachusetts which has an approach that you didn't address. They index on an ad hoc basis the first $7,000 of pension income. By the way, of course, they have tremendous unfunded liabilities. But they have an essential obligation to maintain the floor of security. That is the Chevrolet versus the Cadillac which we in the Federal Government have, where I and my wife are indexed on $81,000. Part of that is Social Security. It should be, it seems to me, restricted to the primary amount of the Social Security benefit, the maximum, around $800, $900 a month, and maybe go another 50 percent if the man is married and his wife is over 65. But I would respectfully suggest that that is a very much more sound approach than just treating them all the same.

Mrs. GRANT. First of all, you are the first person I ever heard that sounded like they are getting too much.

Mr. KEITH. Well, I am a member of a committee that has 50 members and the most articulate of us is a man who retired at 62 with a pension of $385 a month. He now has $1,474 a month. He has only worked for the Treasury Department and he doesn't get Social Security. He writes letters to the editors. If you read your New York Times, the retired major of the Marine Corps wrote protesting that it really was a question of the marketplace and the market basket. He wanted his market basket. But why should the GI who was fighting in the trenches get just the market basket indexed. The average enlisted pensioner gets about $1,000 a month—his COLA is on the cost-of-living portion of his retirement income. There are, however, more than 36,000 military retirees that are getting more than $36,000 a year and Social Security in addition.

Many of them agree with what I have expressed and many of the enlisted would also agree.

Mrs. GRANT. Let me answer your question directly. I did mention, in fact, that approach. I said that one of the approaches, that is, the Massachusetts approach, is to use some percentage of the CPI up to some dollar amount, up to a dollar amount. So you adjust only on the first $10,000 or $20,000 of pension. And that is a typical approach. It is almost unusual to find a plan that adjusts equally at all benefit levels in the private sector. There usually is some kind of cap.

Mr. KEITH. I missed that.

Mr. GALLEHER. My comment would be that Mr. Keith perhaps is unaware there is a plan in the Federal sector where if you feel you are receiving too much, you can voluntarily turn this money back over to the Civil Service retirement system. I am sure he and his committee could be supplied with the forms if they feel obligated.

Mr. SHIPP. Are there questions now about post-retirement adjustment? Andy?

Mr. RUDDOCK. This is just a comment, for anyone who doesn't know it. Most people believe that indexing of Civil Service retirement annuities to the Consumer Price Index was adopted as a benefit to Federal employees, as something that was going to be real good for them. That isn't quite so. The Civil Service Retirement System made post-retirement adjustments on an ad hoc basis by act of Congress up until 1962. It happened that most of those increases were in even numbered years, the same years in which there were elections.

It is also true that most of those increases were exceeding by a considerable amount the increase in the Consumer Price Index that had occurred. So the full indexing to CPI was adopted as a means of keeping down the amount and the cost of post-retirement adjustments.

Now, I don't know whether the climate is right for us to go back to ad hoc increases or not. But when it worked, it sure worked.

Mr. SHIPP. Yes, Mr. Greenough.

Mr. GREENOUGH. I think it is helpful, since the Government is seriously considering the defined contribution approach for part of the benefit, to get it a little more in context.

You pointed out very well that at retirement an employee's accumulated contribution account could be converted into an increasing annuity, which is being done in certain sectors. Where you have investment earnings of say 12 percent, a current inflation rate of 5 percent—a little less than 5 percent—you have a 7 percent beyond inflation real investment earnings there.

Mrs. GRANT. Right.

Mr. GREENOUGH. So it is a very powerful factor.

There are two other things. My pet peeve is where the speaker says the individual assumes the risk without mentioning——

Mrs. GRANT. I always thought risk could be risk of reward or risk of failure.

Mr. GREENOUGH. Then let's only use the word reward without using the word risk——

Mrs. GRANT. OK.

Mr. GREENOUGH [continuing]. For the next 5 years.

Now, it was said that if inflation is high during the contribution period, contributions made early in a career will have relatively little value in relation to final earnings. Actually, the leverage is very great, as you know, from interest earnings. If you take a 15-percent interest rate, which we had during the high inflation, money doubles in 5 years. If you carry out contributions made at age 30 to age 65, you have more than $100,000 for the first $1,000 put in. It is not a minor amount at all; it is very great during a period of inflation. And investment earnings are showing a very real inclination to run ahead of inflation now. We now have real interest earnings substantially positive, where for 20 years we had them essentially zero, or a little bit positive or negative. So the leverage is very great in the defined contribution plan of the kind that the Government could put in.

Mrs. **Grant**. Yes, I think that is very true. As you said, when investment earnings behave, when they really do produce a real rate of return, I think that what was in my mind, at least when I talked about that, was not the most recent couple of years but that long period of time when we had high inflation, very high inflation, and interest rates which lagged behind. I think that that did damage to a lot of defined contribution accounts.

Mr. **Greenough**. That period, however, was relatively short when you take long-term interest rates over 70 or 80 years. It was a period of about 6 or 7 years. But it is so recent that it seems horrendous. It really was a short period.

Mr. **Shipp**. Other questions? Yes?

Mr. **Galleher**. On page 5 of your paper, under the ad hoc approach you speak of, it says:

> The adjustments are customarily related to the inflation rate and made either at specific intervals, such as every two or three years, or after accumulated inflation has reached a certain level, such as 25 percent.

I was wondering if you felt this was a very typical pattern and, if so, if you had any sources that I could look this up in and follow up on it a bit more.

Mrs. **Grant**. It is not uncommon, and I can only tell you that from my own personal experience in dealing with private plans, that relating to both of those comments, after 2 or 3 years, it is typically after inflation has eroded benefits to a certain degree, after accumulated inflation has reached a certain level.

For example, during the periods of very high inflation that we had in the late 1970's, it was common to have ad hoc adjustments every other year. Now companies have not looked at inflation adjustments for 2 or 3 years. And I know many who aren't considering them now because inflation has subsided so considerably. They are waiting until inflation has accumulated enough to make a significant difference in order to make the adjustments.

Now, one thing I didn't mention is that when these adjustments are made at intervals, there is a distinction made in the adjustments given to people who have retired at different periods during the interval since the last adjustment. In other words, the same increase is not given to a person who retired this last year as would be given to somebody who retired 3 years ago, because the person who retired this last year has only been affected by 1 year's worth of inflation and the person who retired 3 years ago has been affected by 3 years. So usually it is a graduated approach to providing post-retirement adjustments, even though it is over every several years.

Mr. GALLEHER. Thank you.

If you wouldn't mind, if I could just relate her comments to the GAO study for a minute.

Mr. SHIPP. We have time for more questions. Yes?

Mr. GALLEHER. They seem to relate. The GAO study, on page 21, talking about the average ad hoc benefit increases, found in a study done by North Carolina State that for participants in plans of 10,000 or more, they got during that period of time a 36.2-percent actual increase, which represented 57.2 percent of the rate of inflation.

How do I relate these two points? The rate of inflation has been highly volatile, as we all know. It has jumped upward and jumped downward. If indeed there is a lag in ad hoc adjustments, that lag could have a major impact on how you would estimate the true catchup in the private sector for the rate of inflation. Let me explain.

If you take the years 1973 to 1979, the amount of inflation in that period of time was about 63 percent, as the study showed. However, if you assume a 2-year lag, or if you assume a 3-year lag, as was mentioned in a paper we were just looking at, then you would appropriately not measure the rate of inflation for 1973 to 1979 but, rather, you would look 2 years before that and 2 years before the end of the period in order to get a measure of your ad hoc increases versus your actual inflation period.

Let me try that one more time. If you assume a 2-year lag for adjustments for inflation, then the inflation increase in 1971 would be paid to the employees in 1973. Likewise, the actual inflation increase in 1977 would be paid to the retirees in 1979. It is very significant.

I worked some numbers while I was sitting here listening to the speech. The amount of inflation between 1971 and 1977, which would be the time period you would look at with a 2-year lag, was only 46.4 percent versus the 63 percent between 1973 and 1979. So what does that do? Because there was a lot less inflation, it means that 36 percent catchup for employees in 10,000 or over plans really represents a lot more than 57.2 percent of inflation, as the GAO would suggest, but it would represent, if you use the 2-year lag plan, 78 percent. If you assume a 3-year lag, it would represent 80 percent.

I think that is very significant in terms of analyzing what is happening in the private sector in terms of ad hoc adjustments. Of course, it is hinged upon, and that is why I asked the speaker the question, whether or not that 2- to 3-year lag is actual or whether it is just a reasonable assumption.

Mrs. GRANT. I didn't mean to imply that there was a 2- to 3-year lag, but only that adjustments are made at 2- or 3-year intervals, so that the inflation during a 3-year period is looked at at the point that the adjustment is made. But certainly what you are saying is related to the fact that it is only made at periodic intervals, and you are looking at adjustments made for a particular period.

Mr. GALLEHER. Right. What the study did that the GAO cited was take the actual inflation rate from 1973 to 1979, roughly 63 percent, whereas if there is a 2-year delay, it should have used an adjustment period, which would show entirely different results.

Mrs. GRANT. I think one of the other reasons is, as I mentioned, that a lower adjustment is usually given to people who retired just in the past year rather than given to people who retired 3 years ago. So if you take just the arithmetic average of all of the adjustments, that would far understate the real adjustments that are given out. Most people would have retired 3 years ago and gotten a bigger adjustment.

Mr. GALLEHER. That point is very well taken. Thank you.

Mr. SHIPP. Question.

Mr. CASTELLS. I don't think we really got back to the reality, or lack of reality, of this 2- to 3-year lag. I don't think that in the private sector, when these increases are given periodically, that they are intended to reflect inflation that had occurred in the period that ended 2 or 3 years prior to when the increase is given.

You do have a bit of a point, and this is the previous questioner, in terms of perhaps the use of that particular period's inflation as the only inflation basis, as being invalid. But equally invalid, if not more so, is using the previous periods which you had suggested. Some mean of the two might be appropriate. But probably where you are getting to is that you don't have enough data to make the statement and that if you want to know what the private sector does generally, there are a lot of professionals here that do advise the major companies, and Dale is certainly one of them. Typically what you are talking about is increases that are meant to replace something along the lines of half of inflation. That has been what companies have been doing. They have pushed it somewhat higher during the periods of extremely high inflation. I wouldn't be surprised if they push it somewhat lower during periods of lower inflation. Thank you.

Mr. SHIPP. Another question?

Rick, did you have any response to that?

Mr. GALLEHER. If I could just follow up on that point. I thought that the paper very well explained the difference between an automatic formula which would imply a commitment and ad hoc which would imply a policy. The point I was making is if either the commitment or policy related to a CPI, we have to all look very carefully when we look at private sector ad hoc adjustments to make sure we do match up the very volatile inflationary periods with the appropriate time periods.

I think, if I don't misunderstand a quick look at an actual study done by North Carolina State, that perhaps the values there are very substantially understated, that indeed the inflation protection could be as high as 80 percent with a group of 10,000 or larger.

Mr. SHIPP. Al, do you want to respond?

Mr. SHANEFELTER. Although the North Carolina State study didn't state so, the corporations whom we visited were adamant they did not make adjustments based on the CPI.

Mrs. GRANT. They didn't make adjustments based on what?

Mr. SHANEFELTER. On CPI increases.

Mrs. GRANT. They lied.

Mr. SHANEFELTER. I can only repeat what they said.

Mrs. GRANT. They didn't make them explicitly. I think there are companies who are very careful when they announce their supplements. First of all, they are very careful not to call them cost-of-living adjustments. They are very careful when they announce their supplement not to relate it to the CPI just because it sets up this expectation. But in designing the supplement, they do look at the CPI.

Mr. SHIPP. Is there a question in the rear?

Mr. COHEN. Just one comment on this preceding discussion.

It seems to me even if there is a delay of 2 years or a lag until there is a catchup, then you have to take into account the fact that the response to inflation is not taking place until some point down the road. If inflation is running at 6 percent a year and you wait 2 years before you do something about it, then you will have a 12-percent decline in the real value of the benefit. And although you may then catch up at that point, you will start losing again until the next benefit increase. So you have to factor this element into the gentleman's comments.

Mr. SHIPP. OK. We have time for one more question. If not, thank you, Dale.

I am certain that Jamie put you at the end of the program, not because of your sex, but because of the nature of your subject. Cost-of-living adjustments is a controversial subject, and one that would keep people awake late in the afternoon.

Jamie asked me to prepare a short summary of these five forums on Federal pensions, and to say a word about what the next challenges are.

During our lunch break, I was talking with two colleagues, both of whom are very experienced in pension issues and who have watched how the Congress deals with pension issues over a number of years. One said, "Well, I am very optimistic because it seems to me that maybe Congress will be able to come to agreement very quickly on the kind of plan it wants. I am very optimistic about that." The other one said, "Don't kid yourself. Discussions at these forums just haven't dealt with the controversial issues and that's the reason there seems to be a lot of agreement."

I don't know which one of these views is correct. The purpose of these forums was not to try to come to any kind of consensus. The letter you got inviting you to this fifth forum was very specific about that. There has never been an attempt to go around the room and ask what participants agree on and what they do not agree on. From the beginning this was labeled an educational process. As such, I think it has been very successful.

Let me read from the statement given by Senator Eagleton at the very first of these forums, in which he said—speaking for Senator Roth, Senator Stevens and Senator Bingaman, as well as himself—the following:

> We concluded that we and others who would be interested, simply needed to learn more about pensions. The most efficient and effective way to cover the topic seemed to be to invite knowledgable persons, experts et cetera, to present information that could be discussed and be debated in a public forum such as this. . . . We hope that these forums will acquaint the Congress and the public with pension issues of the day so that when the politics emerge—the lobbying, the hearings, the actual legisla-

tive drafting—we will all speak with a better understanding of some basic facts and basic data.

These forums have been an education on how pensions work, just like Senator Eagleton said, and the involvement of private sector pension experts has been extremely valuable for those of us who work in the Government.

Based on the discussions we have had today and at the other forums, there may be general agreement among forum participants on basic program structure.

A new Federal retirement system would include Social Security, with perhaps, a defined benefit plan and some kind of voluntary capital accumulation plan. But if there is such an agreement, it simply follows from the kind of data that have been presented that describe what the private sector practice is.

From time to time during our forums, the level of discussion has been somewhat more heated. Questions concerning the level of benefits, overall plan cost, and particularly retirement age and inflation adjustments, are discussed with considerable fervor and emotion, as we have seen today. These will be controversial and very difficult issues for the Congress to deal with.

These forums have been important also to assist us all, including experts from the private sector, to understand the kinds of constraints that the Congress faces in establishing a new Federal retirement system. It will be difficult for the Congress to reach a consensus on some of the most basic objectives of its Federal retirement systems. For example, what type of Federal work force should we have? Now that would seem to be a basic question in designing a pension system, but it is one upon which the Congress would have a difficult time reaching any kind of formal agreement.

Second, it would be difficult for the Congress to consider retirement issues in the context of total compensation. Although some would think that total compensation is the place to begin, questions of Federal pay and other benefits are controversial in and of themselves. To think it would be possible to consider pay issues and retirement issues at the same time really would be optimistic.

A third kind of constraint has to do with the funding of the Civil Service Retirement System. I know there has been a lot of discussion on this issue. The funding of a Federal retirement system has to take account the Federal responsibility for overall fiscal policy in carrying out the mandate of the Employment Act of 1946 and, as has been mentioned today, with the need over the next several years to reduce the Federal deficit.

There has been some talk, as we have gone along, on analytical methods which may assist the Congress in dealing with retirement system issues. I will mention two kinds of analytical methods here, one upon which perhaps there seems to be considerable agreement and the other where agreement would be more difficult.

The first I would label analytical guideposts. The Congress is able to begin its work on Federal retirement systems by starting from what the prevailing private practice is. This private sector pension experience constitutes a guidepost for the Congress. These forums have educated us on private experience. The work of the General Accounting Office will be very helpful in this regard.

Another guidepost that Congress will be conscious of as it proceeds in designing a new Federal system is how closely the new system replicates benefits earned and received under the current system. The Congress may not want to replicate those benefits specifically, but it would be important to know the extent to which a new plan replicates or diverges from the current system.

Analytical methods providing measures of cost wil be more difficult and will provide a large challenge. It will be necessary to determine the cost of a new retirement system, but agreement on how to measure the cost, to say nothing of the level of cost itself, will be difficult. Should it be entry age normal cost? Whose figure for entry age normal cost? How should you take into account budget cost? Measures of benefit adequacy follow from costs, but present measurement problems of their own.

Replacement rates are the basic measure of pension adequacy. These are a powerful analytical tool, but raise a number of methodological questions: Should we talk about gross replacement rates or net replacement rates? Should they be for employees retiring over the next few years or starting to work over the next few years or starting to work over the next few years and retiring 40 years from now? What age and service combinations should be emphasized? And many others.

In summary, then, I would say the forums have been very successful in accomplishing their educational objectives. There is still a lot of work to do and the major challenges lie ahead.

APPENDIX

REPORT BY THE U.S.

General Accounting Office

Features Of Nonfederal Retirement Programs

This report depicts the prevailing features of nonfederal retirement programs as shown by selected studies and/or data bases. Pension plans and capital accumulation plans are analyzed to assist the Congress in its efforts to design new retirement programs for federal employees covered by social security.

GAO/OCG-84-2
JUNE 26, 1984

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-214421

The Honorable William V. Roth, Jr.
Chairman, Committee on Governmental Affairs
United States Senate

The Honorable Ted Stevens
Chairman, Subcommittee on Post Office, Civil
Service, and General Services
Committee on Governmental Affairs
United States Senate

The Honorable Thomas F. Eagleton
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

The Honorable Jeff Bingaman
Ranking Minority Member
Subcommittee on Post Office, Civil Service,
and General Services
Committee on Governmental Affairs
United States Senate

Subject: Features of Nonfederal Retirement Programs (GAO/OCG-84-2)

This report, prepared in response to your joint request of August 5, 1983, analyzes the features of nonfederal retirement programs. As requested, it provides information on public and private sector pension plans as well as related information on capital accumulation plans. A subsequent report will address the levels of benefits employees receive from the nonfederal programs.

In preparing this report, we relied on data developed by other organizations rather than independently collecting new information. In general, these sources focused on retirement programs for salaried employees. Although they were not purported to be statistically representative of all nonfederal sector retirement programs, we found the sources to be sufficiently consistent in their findings that the prevailing features of the retirement programs covered could be readily identified.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report for 30 days. At that time, we will send copies to interested parties and make copies available to others upon request.

Clifford I. Gould

Clifford I. Gould
Assistant to the Comptroller
General for Federal
Retirement Matters

Enclosure

REPORT BY THE UNITED STATES
GENERAL ACCOUNTING OFFICE

FEATURES OF NONFEDERAL
RETIREMENT PROGRAMS

DIGEST

The Congress set December 31, 1985, as the target date for the establishment of new retirement programs for federal civilian employees hired after December 31, 1983. Unlike earlier hires, these employees are covered by social security. If the new programs are not in place by the target date, most new employees will be covered by and contribute fully to both social security and the existing civil service retirement system—a situation that would be very expensive for the employees and the government.

To assist in the design of a new civil service retirement system, the Senate Committee on Governmental Affairs and its Civil Service, Post Office, and General Services Subcommittee asked the General Accounting Office (GAO) to obtain information on retirement programs in the nonfederal sector.

This report concentrates on the features of nonfederal sector retirement programs. A subsequent report will address the levels of benefits employees receive from the nonfederal programs.

GAO used selected surveys and data bases rather than independently collecting new information. The primary sources used were the Bureau of Labor Statistics, the Bankers Trust Company, Hay Associates, the Wyatt Company, Hewitt Associates, and the National Association of State Retirement Administrators. Overall, the surveys focused on retirement programs for salaried employees. (See pp. 1 to 3.)

Retirement programs available in the nonfederal organizations surveyed typically consisted of three parts:

—social security,

—a pension plan, and

—capital accumulation plans.

Since social security will be common to both the newly designed federal programs and the nonfederal sector's programs, GAO's analysis concentrated on the pension and capital accumulation portions of nonfederal programs.

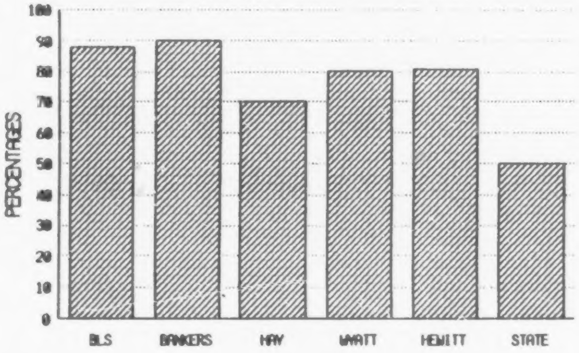
PENSION PLANS

The following sections highlight the prevailing features in the nonfederal pension plans surveyed. Where charts are used, they depict the percentages of the plans or covered employment in which the surveys found the features to exist. (The Bureau of Labor Statistics expressed its findings as percentages of surveyed employees who were covered by the various pension plan features. The other surveys used the number of plans studied as the analytical element.)

Vesting

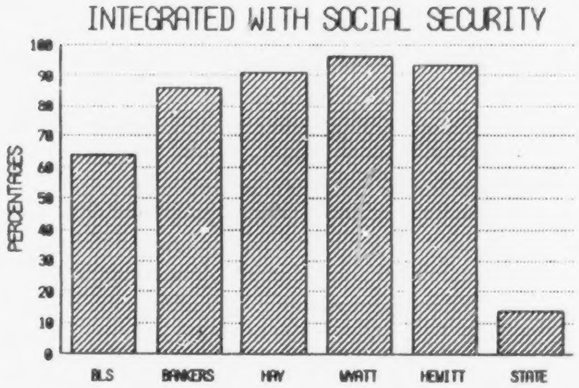
Vesting, in pension terminology, means that point in time at which a plan participant has earned the right to a retirement benefit regardless of whether he/she continues to be employed under the plan. In the nonfederal sector, vesting usually occurs at 10 years of service. (See pp. 4 and 5.)

10 YEAR VESTING OF BENEFITS

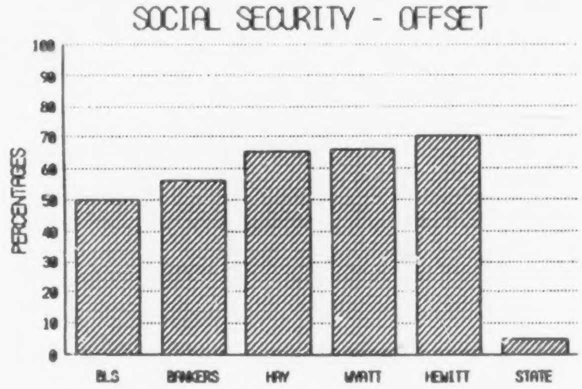


Integration with social security

The prevailing private sector practice is to coordinate or integrate the pension plan with social security. In contrast, most states add pension plan benefits to social security with no integration.

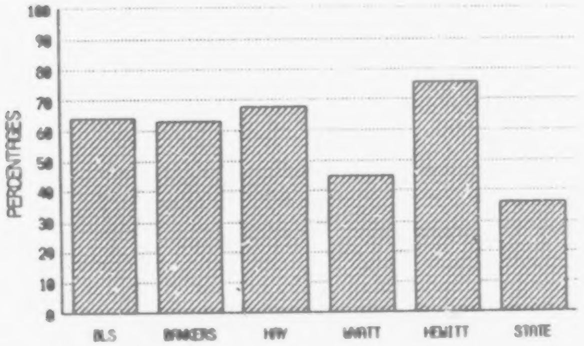

INTEGRATED WITH SOCIAL SECURITY

The method most often used when pension plans are integrated with social security is to offset the amounts the plans would otherwise pay by some portion of social security benefits. (See pp. 5 and 6.)


SOCIAL SECURITY - OFFSET

Pension plan benefits

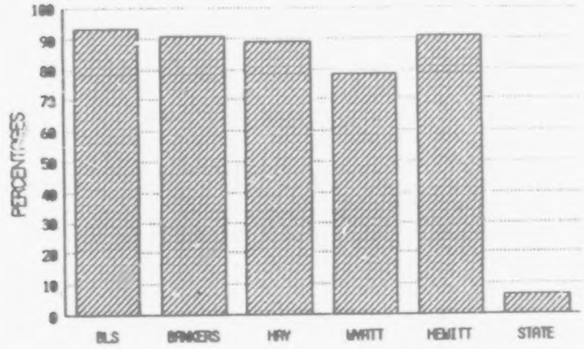
Some nonfederal sector pension plans provide the same benefit amounts for each year of service to all employees—regardless of salary level. However, the Bureau of Labor Statistics data showed the majority of employees surveyed are in plans that apply benefit formulas to the average salary earned in the employee's final years of employment to calculate benefit amounts. Most private sector plans surveyed use a 5-year average salary. Some private sector plans and a slight majority (52 percent) of state plans use a 3-year average salary. (See pp. 6 and 7.)



FINAL AVERAGE SALARY (5-year)

Employee contributions

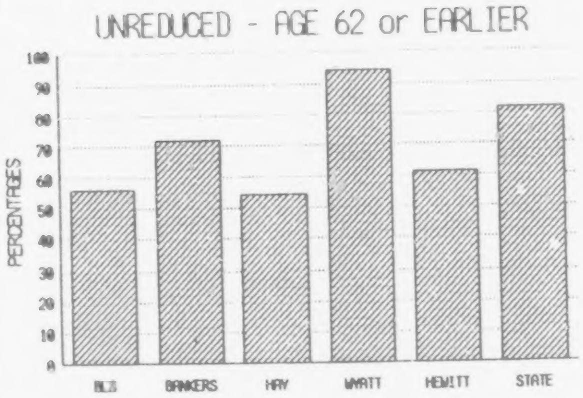
Very few private sector pension plans require employee contributions. By contrast, state plans generally require employee contributions. (See pp. 7 and 8.)



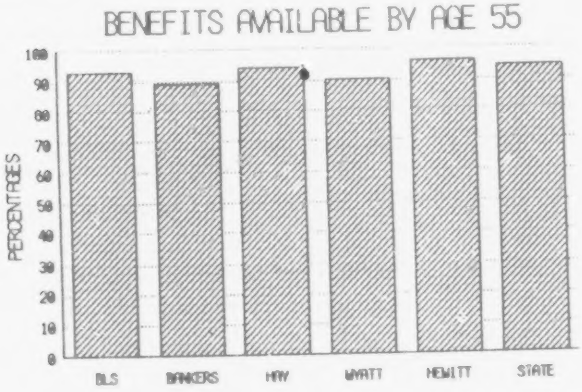
EMPLOYEE CONTRIBUTION NOT REQUIRED

Retirement age

Overall, the studies showed that the earliest age at which employees in the majority of private sector plans could receive unreduced pension benefits was age 62 or younger. In state plans, unreduced benefits were typically payable by age 60. (See pp. 10 and 11.)

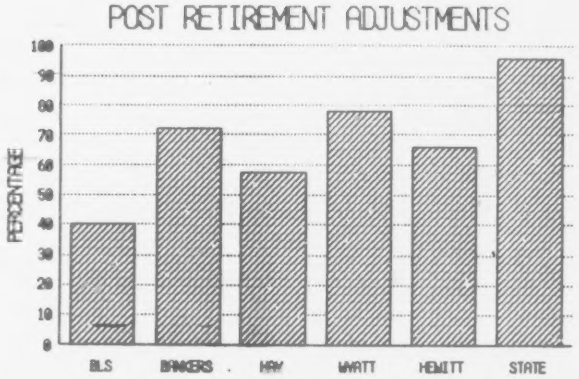


Nonfederal pension plans also permit employees to retire before they attain the requirements necessary for the payment of unreduced benefits. When employees retire early, benefit amounts are reduced. Early retirement is typically available by age 55 in both private sector and state plans. (See pp. 11 and 12.)



Post-retirement adjustments

In addition to the full inflation indexing of retirees' social security benefits, nonfederal employers also provided increases to retirees' pensions. (See p. 20.)



POST RETIREMENT ADJUSTMENTS

These data on pension adjustments were supported in a separate analysis sponsored by the Department of Labor. The study examined pension payments during 1973 to 1979 to a sample of all private sector retirees who were retired in 1972. It found that 75 percent of the retirees had received adjustments to their pension benefits during that time period. According to the study, benefits for all retirees, as a group, increased by amounts equivalent to about 38 percent of the increase in the Consumer Price Index during the period, ranging from about 6 percent for retirees in the smallest plans to 57 percent for retirees in the largest plans. (See pp. 20 and 21.)

Other provisions

In addition to employee pensions, nonfederal sector pension plans may also provide disability and survivor benefits. The provisions shown by the studies for these benefits were as follows:

--Private sector disability benefits may come from the pension plan, a long-term disability insurance plan, or both in addition to social security disability benefits. (See pp. 13 and 14.)

--Long-term disability insurance was the approach most often used by private sector employers with salary-based pension plans. Disabled employees under these plans generally receive benefits of 60 percent or more of pay until they reach retirement age, when deferred pension benefits begin. (See pp. 16 and 17.)

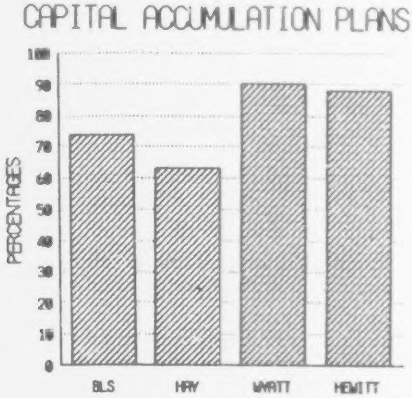
--Only five states used long-term disability insurance. The others provided for disability benefits under the pension plans. (See p. 13.)

--Most private sector pension plans require employees to be eligible for early retirement before survivor benefits are payable upon their death. There was no similar prevailing practice in state pension plans--survivorship eligibility requirements ranged from immediate coverage to eligibility for early retirement. (See pp. 18 and 19.)

--In virtually all the private sector pension plans, retirement benefits were reduced when employees elected survivor benefit coverage. Most private sector plans imposed an actuarial reduction, whereby the reduction in pension benefits was sufficient to cover the anticipated survivor benefit amount. (See pp. 19 and 20.)

CAPITAL ACCUMULATION PLANS

The studies showed that most private sector employers surveyed provide capital accumulation plans as part of the retirement income program. Capital accumulation plans include programs such as employee stock-ownership plans, profit-sharing plans, thrift plans, and deferred compensation plans. (See pp. 22 and 23.)



Of the various types of capital accumulation plans provided in the private sector, the studies showed thrift plans to be the most prevalent. With thrift plans, employers help employees save for retirement and other needs by matching some portion of the employees' contributions to the plan. According to the studies, thrift plans had the following common characteristics:

- —Most employers matched at least 50 percent of employees' contributions up to a specified level. (See pp. 23 and 24.)
- —Employee contributions of at least 6 percent of pay were subject to employer matching in most plans. (See p. 24.)
- —The plans usually required employees to have 1 year of service to be eligible to participate. (See p. 25.)
- —Employees had vested rights to employer contributions in 5 years or less. (See pp. 25 and 26.)

GAO found that tax-sheltered deferred compensation plans authorized by section 401(k) of the Internal Revenue Code are achieving popularity in the private sector. Such plans are similar to thrift plans, but, under the 401(k) approach, employee contributions are considered to be a salary reduction and are not subject to taxation until withdrawn from the plan. (The deferred taxation arrangement applies to employer contributions and earnings on plan investments in both thrift plans and 401(k) plans.) In many instances, companies amended or used existing thrift plans when establishing a 401(k) plan.

Limited information was available on capital accumulation plans in the nonfederal public sector. However, a November 1982 survey of 36 states showed that 33 of them had established or authorized deferred compensation plans for their employees in addition to their pension plans.

TABLE OF CONTENTS

Page

DIGEST i

CHAPTER

1 Introduction 1
  Objectives, scope, and methodology 1
  Structure of nonfederal retirement programs 2

2 Employer Pension Plans 4
  Eligibility for coverage 4
  Vesting provisions 4
  Social security integration 5
  Bases for computing benefits in compensation-based plans 6
  Benefit formulas 7
  Employee contribution requirements 7
  Minimum requirements for unreduced annuity 10
  Early retirement 11
  Supplemental early retirement benefits 12
  Benefits for service after age 65 13
  Disability provisions 13
  LTD insurance plans 16
  Survivor benefits 18
  Post-retirement benefit adjustments 20

3 Capital Accumulation Plans 22
  Prevalence of capital accumulation plans in the private sector 22
  Thrift plans 23
  Deferred compensation plans 27

ABBREVIATIONS

BLS	Bureau of Labor Statistics
CPI	Consumer Price Index
ERISA	Employee Retirement Income Security Act
GAO	General Accounting Office
LTD	long-term disability

CHAPTER 1

INTRODUCTION

The Social Security Amendments of 1983 (Public Law 98-21), primarily intended to resolve financial difficulties in the social security system, had a significant effect on the retirement program for future federal employees. The amendments required that all federal civilian employees first hired after December 31, 1983; former employees returning to federal employment after a break in service of 1 year or more; and elected and politically appointed officials be covered by the social security program. Civilian employees of the government before January 1984 were generally not in social security. Most of them were covered by the civil service retirement system. Others were in retirement systems designed for particular groups of employees, such as the Foreign Service and the Federal Reserve Board retirement systems.

If social security coverage were merely added to the existing retirement systems, the result would be a very costly program with combined benefits at retirement exceeding the salary levels of many employees. Thus, new retirement programs to supplement social security coverage are needed.[1]

On August 5, 1983, the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs and its Civil Service, Post Office, and General Services Subcommittee requested our assistance in the design of a new civil service retirement system. We were asked to collect and analyze information on prevailing retirement features in the nonfederal sector (both public and private) for use by the committee in its assessment of pension policy alternatives. This report contains the results of our analyses.

OBJECTIVES, SCOPE, AND METHODOLOGY

In accomplishing our objectives, we relied on data contained in selected surveys and studies. The scope of the surveys ranged from very large firms to companies employing as few as 50 people. After reviewing (but not verifying) these sources, we concluded they were sufficiently consistent in their findings that prevailing retirement program features could be identified without independent data-gathering on our part. However, they are not presented as statistically representative of all nonfederal sector retirement programs.

As agreed with the committee, our primary source of information was a report by the Department of Labor's Bureau of Labor Statistics (BLS) entitled "Employee Benefits in Medium and Large Firms" and the data bases supporting the report. This report is prepared annually by BLS on the basis of its analysis of retirement and other benefit programs in the private sector establishments used in the federal pay comparability process for salaried employees. Therefore, it is not necessarily representative of the entire private sector. The 1982 report—the last one completed at the time of our review--covered a survey universe of about 21 million employees, of whom an estimated 84 percent, or 17 million employees, participated in pension plans. A total of 976 pension plans was included in the BLS survey. The BLS survey universe included establishments employing as few as 50, 100, or 250 full-time employees, depending on the industry surveyed.

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[1] The dual coverage problem was temporarily resolved by Public Law 98-168, dated November 29, 1983. This legislation provided that, until December 31, 1985, employees covered by both social security and an existing government employee retirement system will be required to contribute no more in total to the two programs than the contributions required of employees who are not in social security. If any such employee becomes eligible to receive benefits from both programs during the period, social security payments will be totally offset against payments from the retirement system.

Other studies we used to supplement and confirm the BLS data were as follows:

--The Bankers Trust Company, "Corporate Pension Plan Study—A Guide for the 1980s." This study included 325 retirement plans in 240 companies, of which the Bankers Trust Company characterized 216 as "large" and 24 as "small." Retirement plans in the 240 companies covered 8.2 million employees.

--Hay Associates, "1983 Hay-Huggins Noncash Compensation Comparison." This study included 781 private sector retirement plans. The study report did not indicate the number of employees covered by the plans, but Hay Associates representatives said that about one-third of the plans surveyed covered 1,000 or fewer employees.

--Hewitt Associates, "Salaried Employee Benefits Provided by Major U.S. Employers in 1982." This report covered 678 private sector retirement plans. The report identified the companies involved but gave no information on the number of employees in the plans.

--The Wyatt Company, "A Survey of Retirement, Thrift, and Profit-Sharing Plans Covering Salaried Employees of 50 Large U.S. Industrial Companies as of January 1, 1983." The report did not contain information on the number of employees in the plans.

--The National Association of State Retirement Plan Administrators, September 30, 1982, "Survey of State Retirement Systems." We used the survey data on general employees (about 2.5 million state employees and about 1.1 million local government employees who participate in the various state plans) and did not use the survey data on special categories of employees such as police, firefighters, and teachers.

Since all the studies did not identify their survey participants, we could not determine the extent to which duplication in participant coverage might exist. Moreover, each of the studies did not always include data on all the retirement program provisions discussed in this report. Where possible, we supplemented the available data with information contained in other, more limited studies. We also visited retirement plan administrators in 10 major corporations.

STRUCTURE OF NONFEDERAL RETIREMENT PROGRAMS

The studies discussed in this report focused primarily on retirement programs for salaried employees. Programs available to these employees in the nonfederal organizations surveyed typically consisted of three parts--social security, a pension plan, and capital accumulation plans.

There are two basic types of pension plans—defined contribution and defined benefit. A defined contribution plan specifies the rate at which funds will be added to each participant's account, and the benefits consist of the accumulated contributions and investment earnings or losses at the time of retirement. Defined benefit plans use specified formulas which consider such factors as salary, age, and years of service to compute benefit amounts. Contributions to defined benefit plans are based on the amounts necessary to fund the benefit payments produced by the formula.

The BLS data showed that 99 percent of the employees in the survey were in defined benefit pension plans and 1 percent in defined contribution pension plans. Only one of the states had a defined contribution pension plan. Five percent of the companies in the Hay Associates survey had defined contribution pension plans. The other studies included only defined benefit plans.

Defined benefit pension plans generally fall into two categories—compensation-based plans and dollar amount plans. Compensation-based plans consider both employees' pay and years of service in the computation of benefits and commonly cover salaried employees. Dollar amount plans provide a flat dollar benefit for each year of service to all covered employees regardless of pay level and commonly cover hourly paid employees. As shown below, 67 percent of the participants in the BLS survey were covered by compensation-based plans.

DEFINED BENEFIT PENSION PLANS FOR WORKERS IN BLS SURVEY

Occupational group	Total	Dollar amount formulas	Compensation-based formulas
	—(percentage of participants)—		
All workers	100	33	67
Professional and administrative	25	2	23
Technical and clerical	26	4	22
Production	49	27	22

Capital accumulation plans are generally supplements to basic pension plans. A wide variety of capital accumulation plans exist, including employee stock-ownership plans, profit-sharing plans, savings and investment plans, and deferred compensation plans. They are considered to be defined contribution plans under provisions of the Employee Retirement Income Security Act (ERISA).

Chapter 2 of this report discusses features of the defined benefit pension plans included in the studies. Chapter 3 discusses features of the capital accumulation plans studied.

Social security is a basic part of all private sector retirement programs. Similarly, employees in 43 states are covered by social security. Thus, social security benefits, as such, are not analyzed in this report other than where necessary to describe how pension plans are designed to recognize the benefits available to employees from social security.

CHAPTER 2

EMPLOYER PENSION PLANS

This chapter describes the provisions of nonfederal defined benefit pension plans as disclosed by the several studies we examined. As will be evident, very few pension plans are alike in all respects. Nevertheless, the predominant, or prevailing, features of the plans as a whole are readily apparent. Each of the studies did not cover all pension plan features. Where a study is omitted as a source, it did not cover the feature being discussed.

ELIGIBILITY FOR COVERAGE

ERISA requires that, if a private sector employer has a pension plan, it must cover all employees when they reach age 25 and have a minimum of 12 months of service. According to BLS, about 70 percent of the employees it surveyed were in plans with participation requirements more liberal than the ERISA requirement. About 39 percent of the BLS survey participants were in plans that granted pension plan coverage immediately upon employment. Another 31 percent were in plans that in some other manner provided coverage earlier than required by ERISA. As shown below, this BLS data agreed with the Bankers Trust Company and Hay Associates surveys:[2]

PENSION PLAN PARTICIPATION REQUIREMENTS

	BLS	Bankers Trust	Hay
	---(percentages)---		
Meet ERISA requirement	30	30	43
More liberal than ERISA	70	70	57

VESTING PROVISIONS

Vesting, in pension terminology, means the point at which a plan participant has earned the right to a retirement benefit regardless of whether he/she continues to be employed under the plan. The BLS survey and other studies indicate that most plans provide for "cliff" vesting, whereby a specified number of years of service must be completed before any benefits vest. In contrast, other plans provide for graduated vesting, whereby employees become entitled to an increasing portion of their accrued pension benefits over time. In the BLS survey, 88 percent of the employees were in plans with cliff vesting at 10 years of service. Similarly, the other studies showed that 70 percent to 90 percent of the private sector plans surveyed had cliff vesting at 10 years. Fifty percent of state government plans had cliff vesting at 10 years. An additional 38 percent of state plans had cliff vesting at 5 years of service.

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[2] The BLS statistics cited here and elsewhere in this chapter use pension plan participants as the analytical element. All the other sources use the number of pension plans studied as the analytical element.

VESTING OF RETIREMENT BENEFITS

	BLS	Bankers Trust	Hewitt	Hay	Wyatt	State
	(percentages)					
Immediate	-	-	1	-	-	-
Cliff vesting						
5 years	-	-	1	-	-	38
10 years	88	90	81	70	80	50
Other	2	2	1	14	-	12
Graduated vesting						
15 years	4	8	12	8	-	-
Other	6	-	4	8	20	-

SOCIAL SECURITY INTEGRATION

A pension plan is integrated with social security to the extent it recognizes social security in establishing benefits. Because social security benefits as a percent of salary decrease as income levels increase, integrated plans attempt to compensate for this decrease.

Pension plans generally use one of two basic approaches--offset or step-rate--to facilitate integration of plan benefits with social security across various income levels. Under the offset approach, a portion of an employee's social security benefit is deducted from the benefits that would otherwise be payable under the plan's pension formula. Under the step-rate approach, the plan benefit formula used to compute an employee's annuity is comprised of two different percentage factors. One percentage factor is applied to that portion of the employee's average earnings below the social security integration level and a second, higher percentage factor is applied to average earnings above the integration level. For example, a plan's benefit formula might provide 1 percent of average earnings up to the social security wage base amount and 1.5 percent of average earnings above the social security wage base amount for each year of service.

Most private sector pension plans included in the surveys were integrated with social security. The BLS data showed that 64 percent of the employees it surveyed were covered by integrated plans. Other studies of private sector plans showed higher percentages of integrated plans ranging from 86 percent to 96 percent.

The data also showed that the offset method was more prevalent than the step-rate method of integrating private sector plan benefits with social security. In the BLS survey, 50 percent of all participants (nearly 80 percent of the participants in integrated plans) were in plans using the offset method.

The other studies also showed that the offset method is used by private sector plans far more frequently than the step-rate method.

State government plans are generally not integrated with social security. Employees in 43 states are covered by social security. In 37 of these states, the pension plan benefits were paid without regard to social security benefits, 4 states used a step-rate approach, and 2 states used the offset method.

INTEGRATION WITH SOCIAL SECURITY

	BLS	Bankers Trust	Hay	Wyatt	Hewitt	State
	(percentages)					
Integrated	64	86	91	96	93	14
Offset method	(50)	(56)	(65)	(66)	(70)	(5)
Step-rate	(14)	(30)	(26)	(30)	(23)	(9)
Not integrated	36	14	9	4	7	86

BASES FOR COMPUTING BENEFITS IN COMPENSATION-BASED PLANS

Data on compensation-based plans showed that an employee's final average salary[3] is the most common basis for computing benefits. In the BLS survey, the benefits for 74 percent of participants in compensation-based plans were based on their final average salary. Benefits for about one-fourth of the participants in the BLS survey were based on career average salary. The other studies showed that a final average salary was used in computing benefits in 76 percent to 98 percent of the private sector plans surveyed. Similarly, nearly all (98 percent) of the state government plans used a final average salary.

The BLS survey showed that 64 percent of the participants in compensation-based plans were in plans using a 5-year average salary. Other studies of private sector plans showed use of the 5-year salary average ranging from 45 percent to 76 percent. The 45-percent figure came from the Wyatt Company's survey of the top 50 Fortune industrial companies. Many of the companies in this survey are in the oil and chemical industries where a 3-year salary average is typically used.

In state government plans, a slight majority (52 percent) of the plans used a 3-year final average salary as the basis for computing benefits.

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[3] The final average salary is that salary earned over the last several years of employment (e.g., 3 to 5 years) and averaged to compute an annual salary.

BASES FOR COMPUTING BENEFITS
IN COMPENSATION-BASED PLANS

	BLS	Bankers Trust	Hay	Wyatt	Hewitt	State
			(percentages)			
Final average salary	74	76	85	98	89	98
3-year average	(7)	(12)	(14)	(49)	(10)	(52)
5-year average	(64)	(63)	(68)	(45)	(76)	(36)
Other	(3)	(1)	(3)	(4)	(3)	(10)
Career average	22	20	9	-	11	2
Other	4	4	6	2	-	-

Furthermore, analysis of the BLS compensation-based plans showed that about 46 percent of the participants were in plans which included more than the employees' basic pay in the compensation base. Other types of compensation included were overtime, shift differentials, bonuses, and commissions.

BENEFIT FORMULAS

Benefit formulas varied considerably with no single formula being a prevailing practice. The social security offset benefit formulas were applied to the largest group of participants in compensation-based plans. The BLS survey showed that the most common benefit accrual rates for participants in these plans were between 1.5 percent and 1.74 percent of final average salary, multiplied by years of service, and offset by 1.5 percent to 1.67 percent of social security benefits for each year of service. The Hay Associates survey found the same accrual rates to be the most common in the offset plans it studied.[4]

EMPLOYEE CONTRIBUTION REQUIREMENTS

All studies showed that few private sector employers require employees to contribute toward the cost of their pension plan benefits. However, most state government pension plans require employee contributions. The BLS data showed that 93 percent of the employees were covered by plans that did not require employee contributions. The other studies also showed that the majority (78 percent to 91 percent) of private sector plans were fully paid for by the employer. On the other hand, 47 states (94 percent of the state plans) required employee contributions.

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[4] As a separate effort, we are determining the benefit amounts that selected nonfederal pension plans would provide to employees at various salary levels, ages, and years of service. A report on this effort will be issued later.

EMPLOYEE CONTRIBUTION REQUIREMENTS

	BLS	Bankers Trust	Hay	Wyatt	Hewitt	State
	(percentages)					
Contributions required	7	9	11	22	9	94
Contributions not required	93	91	89	78	91	6

Of the 47 state pension plans that require employee contributions, 38 plans require all employees to contribute the same percentage of their pay regardless of pay levels. Thirty-one of the 38 states also provide social security coverage. As shown below, 27 of the 31 plans with social security require employees to contribute 6 percent or less of their pay to the plan. The seven plans without social security require employee contributions of 4.25 percent to 8.5 percent of pay.

STATE RETIREMENT PLANS REQUIRING UNIFORM EMPLOYEE CONTRIBUTIONS

	Contribution percentage	Number of plans
Plans with social security		
	2.0	1
	3.0	2
	4.0	5
	4.5	1
	5.0	7
	5.01	1
	5.11	1
	5.57	1
	6.0	8
	7.0	1
	7.85	1
	8.95	1
	Varies by age at enrollment	1
	Subtotal	31
Plans without social security		
	4.25	1
	6.5	1
	7.0	2
	8.0	2
	8.5	1
	Subtotal	7
	Total	38

The other nine state contributory pension plans have variable employee contribution rates, whereby one rate applies below a certain salary level and another rate applies above the specified level. All nine states also provide social security. The contribution requirements in these states are summarized below.

STATE RETIREMENT PLANS WITH
VARIABLE EMPLOYEE CONTRIBUTION RATES

Contribution percentage		
Below specified salary amount	Above specified salary amount	Number of plans
0	5.0	2
2.0	5.0	1
3.0[a]	5.0	2
3.6	4.8	1
3.7	0.0	1
4.0	6.0	1
4.6	9.2	1
Total plans		9

[a] One of these plans requires employee contributions only on salaries over $6,000.

A possible trend in state and local government pension plans is the use of employer "pick up" of employee contributions as authorized by section 414(h)(2) of the Internal Revenue Code. A "pick up" plan permits employees to exclude from current personal taxable income any contributions they make to the pension plan and thereby defer taxation on the contribution amounts until retirement benefits are received. For tax purposes, the contributions are considered to be made by the governmental employer.

According to information published by the Wyatt Company in January 1983, 5 states had statutory authorization to implement, or had implemented, 414(h)(2) plans on a statewide basis; 8 states had authorization to implement, or had implemented, such plans on a local option basis; and another 16 state/local systems were studying the possibility of implementing a 414(h)(2) arrangement.

For example, the state that requires its employees to contribute 8.95 percent of pay (the highest rate in all the states) to its pension plan has a 414(h)(2) plan. The employees' ability to defer taxation on the contributions results in a much lower effective contribution rate.

MINIMUM REQUIREMENTS FOR UNREDUCED ANNUITY

The majority of employees in private sector plans included in the surveys could receive unreduced pension benefits by age 62. In the states, unreduced benefits were typically payable by age 60.

AGE FOR UNREDUCED ANNUITY

	Any age	Age 55	Age 60	Age 62	Age 63-65
	(percentages)				
BLS	13	11	11	21	44
Bankers Trust*	9	11	14	37	28
Hewitt	2	9	14	36	39
Hay	5	6	11	29	49
Wyatt	0	18	38	38	6
State	32	12	32	6	18

*Does not add due to rounding and includes both compensation-based and dollar amount plans

The studies also showed that service requirements were greater when full annuities were available at younger ages. Plans providing unreduced annuities at any age or age 55 generally required 30 years of service. At age 62, plans usually required 10 or fewer years of service.

EARLY RETIREMENT

As a general rule, private sector and state pension plans permit employees to retire before they attain the age and service requirements necessary for the payment of unreduced benefits. As shown below, early retirement is typically available by age 55.

AGE FOR EARLY RETIREMENT

	Any age	Less than age 55	Age 55	Age 60	Age 62
	(percentages)				
BLS*	7	6	82	4	1
Bankers Trust**	15	7	72	6	0
Hewitt	6	7	83	4	0
Hay	13	6	75	6	0
Wyatt	24	6	60	10	0
State	44	8	42	6	0

*Compensation-based plans only

**Includes both compensation-based and dollar amount plans

Private sector and state pension plans require that benefit amounts be reduced when employees retire early.[5] As the following chart shows, BLS, Hay Associates, the Wyatt Company, and state pension plan studies all indicated that percentage reductions, not necessarily based on precise actuarial factors, are most often used in calculating early retirement benefits. Actuarial reductions, based on individual retirees' ages and life expectancies, were used in a few plans.

REDUCTION FACTORS FOR EARLY RETIREMENT BENEFITS

	BLS					
	All formulas	Dollar amount formulas	Compensation-based formulas*	Hay*	Wyatt	State
	(percentage of participants)			(percentage of plans)		
Actuarial	21	23	19	31	6	24
Percentage						
Uniform	46	57	40	25	49	55
Varies by service	3	-	5	-	11	-
Varies by age	30	20	35	45	34	21

*Totals do not add due to rounding

SUPPLEMENTAL EARLY RETIREMENT BENEFITS

In some plans, early retirees receive supplemental benefits. The most common benefit supplement was to delay any offset for social security until social security was payable. The BLS data showed that 3 percent of participants were eligible for this supplement, and, according to other studies containing such data, a range of from 6 percent to 28 percent of the plans delayed the social security offset. The BLS data also showed that 10 percent of the participants were eligible for additional benefits, such as flat dollar amounts or an amount multiplied by years of service with the company, and other studies showed 3 percent and 26 percent of the surveyed plans had additional benefits.

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[5] The effect of early retirement reductions on benefit levels will be more fully explored in our separate analysis of benefits paid by nonfederal plans. (See p. 7.)

SUPPLEMENTAL EARLY RETIREMENT BENEFITS

	BLS			Bankers		
	All formulas	Dollar amount formulas	Compensation-based formulas	Trust	Hay	Wyatt
	(percentage of participants)			(percentage of plans)		
Social security offset delayed	3	1	4	28	6	22
Additional benefits paid	10	21	5	N/A	3	26

BENEFITS FOR SERVICE AFTER AGE 65

The BLS data showed that 58 percent of employees in dollar amount plans received credit for service after age 65, whereas only 35 percent of employees covered by compensation-based plans received such credit. Studies by Hewitt Associates and Hay Associates showed that most plans surveyed did not credit service after age 65. The Wyatt Company's study, on the other hand, indicated that 62 percent of the top 50 companies' plans granted such credit. Also, 76 percent of the states had no limitation on service credits. In the states that had a limitation, it related to the maximum annual benefit the plan would pay to any retiree regardless of age.

BENEFIT CREDITS FOR PRIVATE SECTOR SERVICE AFTER AGE 65

	BLS					
	All formulas	Dollar amount formulas	Compensation-based formulas	Hay	Wyatt	Hewitt
	(percentages)					
Service credited	42	58	35	26	62	38
No service credited	58	42	65	74	38	62

DISABILITY PROVISIONS

According to the studies and data bases, private sector and state employers generally provide disability benefits to employees who are unable to perform their jobs because of physical or mental impairments. The studies showed that, in the private sector, disability benefits may come from the pension plan, a long-term disability (LTD) insurance plan, or both. According to the BLS study, separate LTD insurance plans are used most often to cover employees who participate in compensation-based pension plans. The Hay Associates and Hewitt Associates studies which concentrated on compensation-based plans also indicated this practice. Only five states had LTD insurance plans. The other states provided for disability payments from the retirement plan.

When disability coverage is part of the pension plan, benefits may be payable immediately or deferred until the disabled employee reaches the plan's regular retirement age. The BLS data showed that, overall, most employees were in plans with immediate disability pension benefits. In most cases, these benefits were calculated under the regular pension formula and were not subject to early retirement reductions. Similarly, the majority (96 percent) of the states provided immediate disability pension benefits, and 80 percent provided unreduced benefits.

However, BLS also found that the deferred payment approach was most often used when employees were also covered by LTD insurance plans. Similarly, the Hewitt Associates study showed that about 76 percent of the pension plans it surveyed provided deferred disability pension benefits. Both BLS and Hewitt Associates showed that service credits were usually granted during the deferral period.

The data on private sector disability coverage are summarized below.

DISABILITY BENEFIT COVERAGE

BLS

	All formulas*	Dollar amount formulas	Compensation-based formulas
	(percentage of participants)		
Covered by LTD insurance	47.2	23.0	59.1
Immediate pension plan benefits	(16.2)	(19.5)	(14.6)
Deferred pension plan benefits	(26.2)	(3.2)	(37.5)
No disability benefits in pension plan	(4.8)	(.3)	(7.0)
Not covered by LTD insurance	52.7	77.0	40.9
Immediate pension plan benefits	(42.6)	(69.7)	(29.4)
Deferred pension plan benefits	(4.3)	(1.6)	(5.7)
No disability benefits in pension plan	(5.8)	(5.7)	(5.8)

	Hewitt		Hay	
	Number	Percent	Number	Percent
Companies surveyed	710	100	853	100
Companies with LTD insurance	677	95	791	93
Companies without LTD insurance	33	5	62	7

*Total does not add due to rounding

DISABILITY RETIREMENT BENEFIT PROVISIONS

BLS

	All formulas	Dollar amount formulas	Compensation-based formulas*
	(percentage of participants)		
Immediate disability retirement benefits			
Total	65.9	94.9	50.4
Unreduced regular formula	(50.7)	(79.2)	(35.6)
Reduced regular formula	(8.3)	(8.3)	(8.2)
Other than regular formula	(6.9)	(7.4)	(6.6)
Deferred disability retirement benefits			
Total	34.1	5.1	49.5
Service at time of disability only	(3.7)	(1.0)	(5.1)
Service at time of disability with some additional service credit	(1.0)	(.3)	(1.4)
Service credited to early retirement eligibility or later	(29.4)	(3.8)	(43.0)

Hewitt	Percent of plans
Immediate disability retirement benefits	
Total	23.5
Unreduced regular formula	(20.4)
Reduced regular formula	(3.1)
Deferred disability retirement benefits	
Total	76.5
Service at time of disability only	(18.5)
Service credited to early retirement eligibility or later	(58.0)

*Total does not add due to rounding

According to the BLS data, more than 50 percent of the employees had to have at least 10 years of service to be eligible for disability benefits under the pension plans.

ELIGIBILITY REQUIREMENTS FOR DISABILITY RETIREMENT BENEFITS

BLS

	All formulas*	Dollar amount formulas	Compensation-based formulas*
		(percentages)	
Total	100.0	100.0	100.0
No age or service requirement	15.9	2.6	23.0
Age requirement only	.4	.0	.6
5-9 years service	3.2	4.0	2.8
10-14 years service	32.1	60.3	17.2
15-19 years service	17.5	19.1	16.7
20-24 years service	1.3	2.8	.5
25-29 years service	.2	.2	.2
Other	1.5	.2	2.2
Age and service	7.1	8.8	6.3
Sum age plus service	.7	.0	1.0
Meet LTD insurance requirements	20.0	2.0	29.6

*Totals do not add due to rounding

On the other hand, 38 percent of the states required 5 years' service to be eligible for disability benefits, and an additional 36 percent had a 10-year service requirement.

LTD INSURANCE PLANS

LTD plans are usually contracts with insurance carriers to provide disability benefits for employees. According to BLS, when an employer has an LTD insurance plan, it is the practice for insurance benefits to become available when short-term disability benefits have expired. LTD insurance benefits are paid as long as the disability continues or until such time as the individual reaches retirement age. At that time, retirement benefits are paid, and insurance payments are terminated.

The BLS data showed that 78 percent of the participants covered by LTD insurance plans did not contribute to the plans. Hay Associates and Hewitt Associates data showed that 75 percent and 53 percent, respectively, of the companies surveyed did not require employee contributions for LTD insurance.

EMPLOYEE CONTRIBUTIONS FOR LTD INSURANCE

	BLS	Hay	Hewitt
	—(percentages)—		
Employee contributions required	22	25	47
Employee contributions not required	78	75	53

According to BLS, 61 percent of the participants would receive 60 percent or more of their annual pay from the insurance plan, and another 37 percent would receive at least 50 percent. These are consistent with Hay Associates and Hewitt Associates data showing that 79 percent and 67 percent of the LTD insurance plans provided 60 percent or more of pay. An additional 19 percent and 16 percent of the plans in the Hay Associates and Hewitt Associates surveys provided at least 50 percent.

LTD INSURANCE INCOME AS A PERCENT OF ANNUAL PAY

Percent	BLS	Hay	Hewitt
	—(percentages)—		
Less than 50	2	2	1
50-59	37	19	16
60	46	60	52
65-69	10	17	11
70 or more	5	2	4
Based on years of service	-	-	16

The BLS found the majority of participants would have their LTD insurance benefits reduced when other benefit payments were received. The reductions were for such items as worker's compensation, social security benefits, railroad retirement payments, state disability benefits, and company-sponsored pension benefits.

OFFSETS TO LTD INSURANCE PAYMENTS

BLS

Offsets	Percent of participants
Worker's compensation	
Deduction made	90
No deduction	10
Social security benefit	
Deduction made	88
No deduction	12
Railroad retirement	
Deduction made	90
No deduction	10
State disability benefits	
Deduction made	84
No deduction	16
Employer's pension benefits	
Deduction made	67
No deduction	33

SURVIVOR BENEFITS

The various surveys we reviewed had limited data on pension plan survivor benefits. The most complete information was in the BLS data base.

The BLS data showed that almost 60 percent of the employees had to be eligible for early retirement before survivor benefit coverage was provided by their plans.

ELIGIBILITY REQUIREMENTS FOR
PRE-RETIREMENT SURVIVOR BENEFITS

BLS

	All formulas*	Dollar amount formulas	Compensation-based formulas*
	(percentages)		
Total	100.0	100.0	100.0
No age or service required	1.3	.4	1.7
Age requirement only	3.6	1.8	4.5
5-9 years service	.4	-	.6
10-14 years service	5.2	4.2	5.6
15-19 years service	7.1	11.7	4.8
20-24 years service	.7	-	1.0
25-29 years service	1.6	.5	2.1
30 or more years service	4.8	13.8	.3
Age and service	12.2	9.8	13.3
Sum of age and service	2.1	1.2	2.6
Eligibility for normal retirement	1.5	.6	2.0
Eligibility for early retirement	59.7	55.9	61.5

*Totals do not add due to rounding

However, there was no prevailing practice found on eligibility requirements for pre-retirement survivor benefits in state plans. The requirements range from immediate eligibility for benefits to requiring that individuals be eligible for early retirement before such benefits are available.

The studies showed that a wide range of choices was made available to the private sector retirees with respect to the form in which a survivor benefit may be elected. As shown below, the prevailing practice was to reduce the retiree's benefit actuarially so there was no additional cost to the pension plan when a retiree elected survivor benefits. Comparable data on state pension plans were not available.

SURVIVOR BENEFIT REDUCTIONS

	BLS			Hay
	All formulas	Dollar amount formulas	Compensation-based formulas	(percent of plans)
	(percent of participants)			
Benefit reduced actuarially	76	62	83	89
Benefit reduced less than actuarially	19	35	10	2
No reduction	5	3	7	9

POST-RETIREMENT BENEFIT ADJUSTMENTS

Social security benefits paid to nonfederal sector retirees are fully indexed for inflation. The studies showed that many private sector and state pension plans also adjusted benefit amounts after retirement.

In private sector plans, adjustments are usually granted on an ad hoc basis. The BLS data showed that 40 percent of the surveyed participants were in plans that had granted at least one adjustment during 1978 to 1981, and 93 percent of them were made on an ad hoc basis. The other private sector studies showed that from 57 percent to 78 percent of the plans they covered had granted adjustments in about the same time period.

PRIVATE SECTOR POST-RETIREMENT ADJUSTMENTS

	BLS 1978-81	Bankers Trust 1975-80	Hay 1976-82	Wyatt 1980-82	Hewitt 1978-82
	(percentage of total)				
At least one adjustment given	40	72	57	78	66
No adjustment given	60	28	43	22	34

A broad-based study by North Carolina State University for the Department of Labor supported the above data. This study, entitled "Inflation and Benefits, A Study of COLA Adjustments and Pensions in the Private Sector," examined pension payments during 1973 to 1979 to a statistical sample of all private sector retirees who were retired in 1972. The study found that 75 percent of the retirees had received adjustments during the 1973-79 time period, with one-third to one-half of all retirees receiving adjustments in any given year. About 25 percent had received adjustments every year.

The Labor study showed that the magnitude of post-retirement adjustments varied substantially by plan size, with larger plans granting the greatest increases. As shown below, the average increase during the time period for all retirees, including those who received no adjustments, was 24 percent. The increases ranged from 3.5 percent for retirees in the smallest plans to 36.2 percent for retirees in the largest plans. As a percentage of the increase in the CPI during the period, the adjustments averaged 37.9 percent, ranging from 5.5 percent for the smallest plans to 57.2 percent for the largest plans.

AVERAGE BENEFIT INCREASES BY PLAN SIZE
1973-1979

Number of plan recipients	Average percentage increase	Average increase as percentage of CPI increase
1-99	3.5	5.5
100-499	14.9	23.5
500-999	13.8	21.8
1,000-4,999	9.6	15.2
5,000-9,999	21.0	33.2
10,000 and over	36.2	57.2
Overall average	24.0	37.9

Thirty (60 percent) state pension plans provided for automatic adjustments based on increases in the CPI. Such automatic increases were generally limited to 3 percent of pension amounts each year. In 18 states (36 percent), adjustments were granted on an ad hoc basis, and 2 states (4 percent) did not adjust benefits.

CHAPTER 3

CAPITAL ACCUMULATION PLANS

In addition to social security and pension plans, many nonfederal employers provide capital accumulation plans as a third component of their employees' retirement income packages. Some employers sponsor more than one type of plan. This chapter focuses on the capital accumulation plans we found to be the most prevalent in the nonfederal sector--savings and investment plans (more commonly known as thrift plans) and deferred compensation plans.

Data we reviewed on capital accumulation plans primarily concerned private sector practices. Little information was available on such plans in state and local governments. However, we did note that a November 1982 survey by the Council of State Governments showed that all but 3 of the 36 states surveyed had established or authorized deferred compensation plans for their employees in addition to their pension plans.

PREVALENCE OF CAPITAL ACCUMULATION PLANS IN THE PRIVATE SECTOR

With the exception of the Bankers Trust Company, which made a separate analysis of thrift plans only, all the studies of private sector retirement programs covered a range of capital accumulation plans. As shown below, these studies indicated that the majority of the companies surveyed provided capital accumulation plans as part of the retirement income package. The BLS data shows that 74 percent of the establishments it surveyed had capital accumulation plans. The percentages of companies with capital accumulation plans in the Hay Associates, Hewitt Associates, and the Wyatt Company studies were 63 percent, 88 percent, and 98 percent, respectively.

AVAILABILITY OF CAPITAL ACCUMULATION PLANS

	BLS	Hay	Hewitt	Wyatt
Number of companies surveyed	1,287	849	710	50
Number of companies with plans	958	533	623	49
Percent of companies with plans	74	63	88	98
Percent of surveyed companies with both defined benefit pension plans and capital accumulation plans	64	56	83	98

The studies and data showed the following breakdown by type of capital accumulation plan in the companies surveyed.

TYPE OF CAPITAL ACCUMULATION PLANS PROVIDED

	BLS	Hay	Hewitt	Wyatt
Thrift plan	193	367	215	14
Thrift and stock-ownership plans	199	[a]	202	26
Thrift and profit-sharing plans	80	—	42	—
Profit-sharing plan	223	166	70	2
Profit-sharing and stock-ownership plan	86	[a]	52	5
Stock-ownership plan	177	[a]	42	2
Total	958	533	623	49

[a] 160 companies had stock-ownership plans, but data was not available to determine whether any or all plans were in addition to thrift or profit-sharing plans.

THRIFT PLANS

Thrift plans are a type of capital accumulation plan wherein employers help employees save for retirement and other needs by matching some portion of the employees' contributions to the plan. (In a few cases, employers contribute to employee thrift accounts without requiring any employee contributions.) Employer contributions and investment income are not taxable to the employee until funds are withdrawn.

The studies showed that employer-matching percentages were usually at fixed rates which ranged from 10 percent to over 100 percent of employee contributions. However, the amount of employee contributions subject to employer matching was generally limited to a specified percentage of pay. As shown in the following tables, most employers matched at least 50 percent of employee contributions up to a specified level. Employee contributions of at least 6 percent of pay were subject to employer matching in most plans.

PERCENTAGE OF EMPLOYEE CONTRIBUTIONS MATCHED BY EMPLOYER

Employer-matching percentage	Hewitt	Hay	Bankers Trust	Wyatt
	—(percentage	of	companies)—	
10-20	2	2	6	-
25	9	6	11	-
30-45	4	4	9	2
50	41	41	46	29
55-95	6	7	4	13
100	15	15	14	31
Over 100	2	1	2	2
Varies by profit	10	13	-	5
Varies by amount of employee contribution	3	-	-	2
Varies by years of participation or service	8	10	-	8
Other	-	1	8	8
Total	100	100	100	100

MAXIMUM EMPLOYEE CONTRIBUTION USED IN EMPLOYER-MATCHING FORMULA

Employee contribution (percent of pay)	Hewitt	Hay	Bankers Trust	Wyatt
	——(percent	of	companies)—	
2	3	3	3	2
3	5	7	4	2
4	8	10	9	-
5	17	16	19	10
6	56	54	44	39
Over 6	10	10	16	18
Other (flat dollar amount)	1	-	5	29
Total	100	100	100	100

The Hay Associates and Hewitt Associates studies also showed that most plans surveyed allowed employees to contribute amounts above the employer-matching level. In most cases, unmatched employee contributions of 6 percent of pay or more were allowed.

EMPLOYEE CONTRIBUTIONS ABOVE THE EMPLOYER-MATCHING LEVEL

Percent of compensation	Hewitt	Hay
	(percentage of companies)	
2-5	37	41
6-9	23	40
10 or more	40	19
Total	100	100

Thrift plan eligibility requirements

The studies showed that the majority of thrift plans permitted employees to participate in the plan after being employed for 1 year.

THRIFT PLAN SERVICE ELIGIBILITY REQUIREMENTS

	Bankers Trust	Hay*	Wyatt*
	(percentages)		
Immediate coverage	10	11	11
6 months or less	18	13	16
1 year	67	70	71
Over 1 year	5	5	3

*Totals do not add due to rounding

Vesting in employer contributions to thrift plans

The studies showed that most thrift plans provided for employee vesting in employer contributions in 5 years or less.

THRIFT PLANS
VESTING IN EMPLOYER CONTRIBUTIONS

	Bankers Trust	Hay
	-(percentages)-	
Immediate	11	17
Class year[a]		
Less than 3 years	15	7
3 years	14	6
More than 3 years	12	4
Service/participation[a]		
Less than 5 years	7	15
5 years	25	29
6-9 years	8	7
10 or more years	8	15
Total	100	100

[a] Class year is a form of graduated vesting and service/participation is a form of cliff vesting as defined on page 4.

Employee participation in thrift plans

According to the studies, most eligible employees participated in their employers' thrift plans. The studies showed participation rates of at least 65 percent in the majority of the plans. There was also a relationship between employer-matching percentages and employee participation--the higher the matching percentage, the more employees participated.

EMPLOYEE PARTICIPATION IN THRIFT PLANS

Percentage of eligible employees participating	Hay	Bankers Trust
	(percentage of plans)	
Less than 50	12	17.6
50-64	18	19.5
65-74	23	19.9
75-89	36	30.0
90-100	11	13.0
Total	100	100.0

Employer-matching percentages	Hewitt	Bankers Trust
	(percentage of participating eligible employees)	
25	63	52
50	65	73
100	74	86
Average	67	70

DEFERRED COMPENSATION PLANS

A recent innovation in the capital accumulation portion of nonfederal retirement programs has been the use of deferred compensation plans authorized by section 401(k) of the Internal Revenue Code. These plans contain many features of thrift plans (the major difference being that employee contributions to 401(k) plans are made with pre-income tax dollars). The Internal Revenue Service issued proposed regulations in November 1981, but final regulations have not yet been issued. However, despite the lack of final regulations, 401(k) plans have grown in popularity and provide tax-sheltered retirement funds for those employees who participate.

Under the 401(k) approach, an employee can elect to defer a portion of his/her salary and have the employer deposit the deferred amount into an investment account. The amount of the salary deferral, any employer contributions to the account, and investment earnings are exempt from personal income taxes until the employee withdraws the funds. Funds from 401(k) plans can be withdrawn upon the employee's retirement, death, disability, separation from service, attainment of age 59-1/2, or demonstration of financial hardship.

There was limited data available on 401(k) plans in the surveys we used in our analysis of nonfederal retirement programs. Consequently, we supplemented them with the following surveys:

—"Hot Topics in Retirement Plans, A Survey of the Hewitt Compensation Exchange," Hewitt Associates, 1983. A survey of 307 corporations.

—"Salary Reduction Plans: Design Features and Experience, A TPF&C Survey Report, November 1983," Towers, Perrin, Forster, and Crosby, 1983. A survey of 79 companies with 401(k) plans.

—"The Use of 401(k) Plans by Medium Sized Companies, A Meidinger Survey," Meidinger, Inc., 1983. A survey of 256 medium sized companies in 38 states.

According to the data, more than half of the companies surveyed (ranging from 50 percent to 70 percent in the various surveys) had adopted, were in the process of adopting, or were considering adopting a 401(k) plan. More importantly, only 6 percent of the companies in one survey and 12.6 percent in a second survey had definitely decided not to adopt a 401(k) plan.

In all of the surveys, it was the common practice (from 76 percent to 84 percent) for the employer to match part or all of employees' salary deferrals. The data indicated that a 50-percent match was the most prevalent practice. Six percent of pay was the most frequently permitted deferral subject to matching, although a few companies permitted much higher amounts (16 percent and 20 percent in two of the studies). In many instances, companies amended or used an existing thrift plan when establishing a 401(k) plan.

In 401(k) plans, the higher paid third of employees eligible to participate in the plan are not permitted to defer a substantially greater percentage of their salary than the lower paid two-thirds of employees. Hewitt Associates and Towers, Perrin, Forster, and Crosby studies showed that the median deferred percentage was 4.6 percent and 4.89 percent for the higher paid third of employees and 2.8 percent and 3.43 percent for the lower paid two-thirds of employees. According to Hay Associates, deferrals ranged from 1 percent to 10 percent of pay, with most deferrals being 4 percent to 7 percent, and data from Hewitt Associates indicated that the average deferral for all employees was about twice as large when the employer made matching contributions.

BENEFIT FORMULAS

A PRESENTATION TO THE UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON CIVIL SERVICE, POST OFFICE, AND GENERAL SERVICES

POLICY FORUM
ON
PROGRAM OPTIONS
JULY 10, 1984

PREPARED BY:

HARPER L. GARRETT JR., F.S.A.
VICE PRESIDENT & DIRECTOR OF PROFESSIONAL SERVICES
ALEXANDER & ALEXANDER INC.

THERE ARE TWO BASIC METHODS OF PROVIDING FOR RETIREMENT INCOME, EITHER THROUGH APPLICATION OF A BENEFIT FORMULA IN A DEFINED BENEFIT PLAN, OR THROUGH AN ACCUMULATION OF MONIES IN A DEFINED CONTRIBUTION PLAN. THE MOST COMPREHENSIVE DEFINITION OF A BENEFIT FORMULA APPLIES WHEN DISCUSSING DEFINED BENEFIT PLANS, AND IT MUST INCLUDE SPECIFIC ANSWERS TO THE FOLLOWING QUESTIONS: HOW MUCH THE BENEFIT IS TO BE, WHEN IT IS TO BE PAID, AND HOW IT IS TO BE PAID. IN OTHER WORDS, THE BENEFIT FORMULA WILL DEFINE THE BENEFIT ACCRUAL RATE, THE NORMAL RETIREMENT AGE, AND THE FORM OF PAYMENT, E.G. A LIFE ANNUITY, A JOINT AND SURVIVOR ANNUITY OR PERHAPS A LUMP SUM.

I'VE BEEN ASKED TO CONCENTRATE MY REMARKS TODAY PRIMARILY ON THAT PORTION OF THIS DEFINITION DEALING WITH THE ACCRUAL RATE. THEREFORE I'LL BE DISCUSSING VARIOUS BENEFIT FORMULAS, WITH REGARD TO THE COMPENSATION BASE USED, PATTERNS OF BENEFIT ACCRUAL (INCLUDING FRONT-LOADING AND BACK-LOADING) AND SOCIAL SECURITY INTEGRATION FORMULAS. I'LL ALSO TRY TO FOCUS ON HOW EACH OF THESE AFFECTS A DEFINED BENEFIT PLAN AND A DEFINED CONTRIBUTION PLAN. I PLAN TO COVER DEFINED BENEFIT PLANS FIRST.

BEFORE I GET TO ACCRUAL RATES, HOWEVER, I DO WANT TO ADDRESS BRIEFLY THE RETIREMENT AGE AND FORM OF PAYMENT. IN THE CORPORATE WORLD, AGE 65 IS ALMOST UNIVERSALLY THE NORMAL RETIREMENT AGE SPECIFIED IN THE PLAN. HOWEVER, AN IMPORTANT ELEMENT OF THE BENEFIT FORMULA RELATED TO THE RETIREMENT AGE IS THE EARLY RETIREMENT PROVISION; IN OTHER WORDS, SOME EMPLOYERS ENCOURAGE EARLY RETIREMENT BY PERMITTING EMPLOYEES TO RETIRE EARLIER THAN THE NORMAL RETIREMENT AGE WITH LESS THAN A FULL ACTUARIAL REDUCTION IN THE BENEFIT. THIS IS

KNOWN AS SUBSIDIZED EARLY RETIREMENT AND CERTAINLY INCREASES THE COST OF THE PLAN. IN MANY CORPORATE PLANS, AND CERTAINLY IN MOST OF THE VERY LARGE PLANS, RETIREMENT AT AGE 62 WITH FULL UNREDUCED BENEFITS IS NOT UNCOMMON, AND IN THESE SITUATIONS, AGE 62 CAN GENERALLY BE CONSIDERED THE DE FACTO NORMAL RETIREMENT AGE. I SHOULD ALSO NOTE THAT THERE ARE A NUMBER OF PLANS IN PRIVATE INDUSTRY WHERE AN EMPLOYEE MAY RETIRE WITH FULL UNREDUCED BENEFITS DEPENDING ON COMBINATIONS OF SERVICE AND AGE, E.G. AGE 60 WITH 20 YEARS OF SERVICE OR AGE 55 WITH 30 YEARS OF SERVICE, ETC., SIMILAR TO THE CURRENT CIVIL SERVICE RETIREMENT SYSTEM. DEFERRED RETIREMENT MAY OR MAY NOT PROVIDE FOR A CONTINUATION OF BENEFIT ACCRUALS AND THIS IN TURN CAN AFFECT THE COST OF THE PLAN, ALTHOUGH DEFERRED RETIREMENT GENERALLY REDUCES THE COST OF THE PLAN.

FINALLY, JUST A WORD ON THE FORM OF PAYMENT OF THE BENEFIT, I.E., THE WAY IN WHICH IT WILL BE PAID. IN PRIVATE INDUSTRY NON-CONTRIBUTORY PLANS THE NORMAL FORM IS A LIFE ANNUITY. MOST PLANS ALSO OFFER THE EMPLOYEE THE SELECTION OF SEVERAL OTHER OPTIONS SUCH AS LIFE AND 10 YEAR CERTAIN OR JOINT AND 50% SURVIVOR, ETC. EACH OF THESE FORMS IS CALCULATED AS AN ACTUARIAL EQUIVALENT TO THE LIFE ANNUITY. FOR EXAMPLE, IF AN EMPLOYEE WAS SCHEDULED TO RECEIVE $100 A MONTH AT AGE 65 AS A LIFE ANNUITY, AND INSTEAD ELECTED TO RECEIVE A 10 YEAR CERTAIN AND LIFE THEREAFTER ANNUITY THE BENEFIT WOULD THEN BE REDUCED TO $91 PER MONTH. IN OTHER WORDS, THIS LOWER DOLLAR AMOUNT, WHICH IS EFFECTIVELY GUARANTEED FOR AT LEAST 10 YEARS AND THEN FOR LIFE THEREAFTER IS ACTUARIALLY EQUIVALENT TO $100 A MONTH PAYABLE FOR LIFE.

A COROLLARY TO THE FORM OF PAYMENT MIGHT ALSO BE WHETHER SUCH PAYMENT IS TO BE CONSTANT IN AMOUNT, OR WILL INCREASE IN AMOUNT OVER TIME TO RECOGNIZE COST OF LIVING INCREASES. VERY FEW PRIVATE PLANS AUTOMATICALLY INCREASE PAYMENTS TO RETIREES; INSTEAD UTILIZING OCCASIONAL AD HOC INCREASES, BUT EVEN HERE, RARELY IF EVER IS THE FULL IMPACT OF COST OF LIVING RECOGNIZED. THE CIVIL SERVICE RETIREMENT SYSTEM NORMAL FORM OF BENEFIT (UNLIKE THE OVERWHELMING MAJORITY OF PRIVATE PLANS) IS INDEXED TO THE COST OF LIVING, AND THIS HAS A SIGNIFICANT COST IMPACT.

I DO NOT WANT TO SPEND ANY MORE TIME THIS MORNING ON THESE LATTER TWO BENEFIT FORMULA DETERMINANTS, BUT I DID WANT TO AT LEAST NOTE THEIR IMPACT ON THE COST. IN THE FIRST POLICY FORUM THERE WAS AN EXCELLENT PAPER PRESENTED BY DR. DAN MCGILL, WHICH GOES INTO CONSIDERABLE DETAIL ON THE IMPACT ON COST OF BOTH THE NORMAL RETIREMENT AGE AND THE NORMAL FORM OF ANNUITY. I WOULD REFER ANYONE DESIRING MORE INFORMATION TO HIS PAPER. IN ADDITION, OF COURSE, THIS MORNING THE NEXT SPEAKER IS GOING TO DISCUSS THE TOPIC OF RETIREMENT AGES. SO ENOUGH FOR NOW ON THESE TWO IMPORTANT ASPECTS OF BENEFIT FORMULAS.

ALTHOUGH THE PAST FOUR POLICY FORUMS HAVE COVERED, IN ONE WAY OR ANOTHER, MOST OF THE TOPICS ABOUT WHICH YOU'LL BE HEARING TODAY, THE COMMITTEE STAFF FELT IT WOULD BE USEFUL IF WE WERE TO DEVOTE THIS FINAL FORUM TO ADDRESSING SOME OF THE MAJOR ASPECTS OF PLAN DESIGN, IN ORDER THAT YOU OBTAIN SOME FEEL OF HOW EACH OF THESE ASPECTS AFFECTS THE AMOUNT OF BENEFITS AND/OR THE COST OF SUCH BENEFITS.

AS CONSULTANTS, ONE OF THE WAYS IN WHICH WE SEEK TO ASSIST EMPLOYERS IN PENSION PLAN DESIGN IS TO HELP THEM ASCERTAIN WHAT THE RETIREMENT INCOME OBJECTIVE OF THEIR PLAN SHOULD BE. IN BROAD TERMS, THIS GENERALLY IS EXPRESSED AS THE AMOUNT OF INCOME THAT IS ADEQUATE TO MAINTAIN THE RETIRED WORKER AND HIS DEPENDENTS ON A STANDARD OF LIVING REASONABLY CONSISTENT WITH THAT WHICH THEY ENJOYED DURING THEIR PRE-RETIREMENT YEARS. THIS NORMALLY TAKES ACCOUNT OF THE COMBINED BENEFITS PAYABLE FROM THE PRIVATE PENSION PLAN AND PAYABLE FROM SOCIAL SECURITY TO THE INDIVIDUAL.

IF YOU WILL RECALL, ONE PORTION OF THE FIRST POLICY FORUM DEALT ENTIRELY WITH THE TOPIC OF WHAT IS KNOWN AS REPLACEMENT RATIOS, I.E. THE PERCENTAGE OF RETIREMENT BENEFITS, INCLUDING SOCIAL SECURITY, AS COMPARED TO THE PRE-RETIREMENT INCOME. REPLACEMENT RATIOS ARE GENERALLY LESS THAN 100%, FOR FAIRLY OBVIOUS REASONS, SUCH AS:

1. TAXES OF THE RETIRED EMPLOYEE ARE LESS THAN THOSE OF AN ACTIVE EMPLOYEE.

2. CERTAIN EXPENSES ASSOCIATED WITH EMPLOYMENT NO LONGER EXIST (COMMUTING, CLOTHES, MEALS AWAY FROM HOME, ETC.).

3. THE COST OF SUPPORTING CHILDREN HAS GENERALLY CEASED.

4. MORTGAGE PAYMENTS HAVE GENERALLY CEASED.

THEREFORE, TYPICAL REPLACEMENT RATIO OBJECTIVES IN CORPORATE PLANS RANGE FROM ABOUT 50%-60% FOR HIGHER PAID EMPLOYEES UP TO ABOUT 70%-80% FOR LOWER PAID EMPLOYEES.

IN ADDITION, I SHOULD NOTE THAT THESE REPLACEMENT RATIOS ARE GENERALLY TARGETED TOWARD A "FULL SERVICE" EMPLOYEE, I.E. ONE WHO HAS RENDERED 30 OR PERHAPS 40 YEARS OF SERVICE WITH ONE EMPLOYER.

IN COMPARISON, THE CIVIL SERVICE RETIREMENT SYSTEM PROVIDES THE SAME REPLACEMENT RATIO FOR A LOW PAID OR A HIGH PAID EMPLOYEE IF EACH HAS THE SAME LENGTH OF SERVICE.

YOU WILL NOTE THAT IN COMPUTING REPLACEMENT RATIOS, THE INDIVIDUAL'S PERSONAL SAVINGS ARE GENERALLY NOT TAKEN INTO ACCOUNT. MOST OF US NEED ONLY LOOK AT OUR OWN PERSONAL CUMULATIVE SAVINGS TO UNDERSTAND WHY THIS IS SO. BRIEFLY, ONE'S PERSONAL SAVINGS WOULD NORMALLY NOT PROVIDE A VERY SUBSTANTIAL AMOUNT OF RETIREMENT INCOME WHEN CONVERTED INTO AN ANNUITY STREAM. ANY PERSONAL SAVINGS MAY SIMPLY BE THOUGHT OF AS A SUPPLEMENT TO THE RETIREMENT INCOME.

I MENTION THE REPLACEMENT RATIO IN SOME DETAIL AGAIN TODAY ONLY TO EMPHASIZE THE POINT THAT IN STARTING TO DESIGN ANY TYPE OF RETIREMENT PLAN IT IS ABSOLUTELY NECESSARY TO HAVE A GOAL, AND THAT GOAL IN THE PRIVATE SECTOR IS GENERALLY EXPRESSED EITHER AS THE BENEFIT OBJECTIVE, OR THE COST TO PROVIDE BENEFITS. OUR EMPHASIS THIS MORNING IS ON DISCUSSING BENEFIT DESIGN, BUT LET ME JUST SAY AT THE OUTSET

THAT WHENEVER ANY ONE OF US IS DISCUSSING ONE BENEFIT WHICH IS RICHER THAN ANOTHER, KEEP IN MIND THE OBVIOUS COROLLARY THAT THE RICHER BENEFIT IS ALSO ALWAYS COSTLIER TO FUND.

NOW I BELIEVE WE'RE READY TO TURN OUR ATTENTION TO ACCRUAL RATES, AND HOW THEY CAN BE USED TO PRODUCE THE DESIRED REPLACEMENT RATIOS. THERE ARE A NUMBER OF WAYS TO APPROACH THIS TOPIC BUT LET ME CHOOSE ONE OF THE MORE TRADITIONAL ONES AND FIRST DEFINE BENEFIT FORMULAS UNDER TWO BROAD CATEGORIES: UNIT BENEFIT AND FLAT BENEFIT. WE WILL DISCUSS UNIT BENEFIT PLANS FIRST. THE NAME MEANS JUST WHAT IT SOUNDS LIKE IT MEANS. IN EACH YEAR OF SERVICE A SPECIFIC UNIT OF BENEFIT IS CREDITED TOWARDS RETIREMENT. HOWEVER, HERE AGAIN WE MUST FIRST CATEGORIZE THE UNIT OF BENEFIT AS EITHER A DOLLAR AMOUNT OR A PERCENTAGE OF PAY. WHERE IT IS A DOLLAR AMOUNT, AS IS OFTEN THE CASE IN UNION NEGOTIATED PLANS, A TYPICAL MONTHLY BENEFIT FOR EACH YEAR OF SERVICE MIGHT BE $10. UNDER SUCH A PLAN, SOMEONE RETIRING WITH 30 YEARS OF SERVICE WOULD THEREFORE RECEIVE $300 PER MONTH IN RETIREMENT INCOME.

WITH REGARD TO THOSE UNIT BENEFIT PLANS IN WHICH THE UNITS ARE EXPRESSED AS A PERCENTAGE OF PAY, AND ARE THEREFORE TIED TO COMPENSATION, WE IMMEDIATELY RUN INTO THREE QUESTIONS WHICH WE MUST ANSWER. THESE ARE:

1. WHAT IS THE DEFINITION OF COMPENSATION? (I.E. BASE SALARY ONLY, OR ALSO INCLUDING OVERTIME, COMMISSIONS, BONUS, ETC.).

2. WHAT IS THE BASIS OF COMPENSATION? (CAREER AVERAGE OR FINAL AVERAGE SALARY)

3. WHAT IS THE AVERAGING PERIOD FOR COMPENSATION? (FINAL OR HIGHEST AVERAGE 3 YEARS, 5 YEARS, OR 10 YEARS).

NOTE THAT ALL THREE OF THESE QUESTIONS HAVE TO DO WITH THE FACT THAT IN DEFINING UNIT BENEFIT, WE BROUGHT IN THE WORD "PAY" AND EACH QUESTION RELATES IN SOME WAY TO PAY.

THERE REALLY IS ANOTHER QUESTION TO ASK REGARDING THE WORD "BENEFIT" AND THAT IS, "IS THE BENEFIT GOING TO BE COORDINATED, I.E., INTEGRATED WITH SOCIAL SECURITY OR NOT"? ACTUALLY, MORE SPECIFICALLY THE QUESTION SHOULD BE IS THE BENEFIT GOING TO EXPLICITLY INTEGRATE OR IMPLICITLY INTEGRATE WITH SOCIAL SECURITY. LET ME ELABORATE ON THIS LATTER POINT FOR A MOMENT. TODAY THE OVERWHELMING MAJORITY OF ALL CORPORATE PLANS TAKE ACCOUNT OF SOCIAL SECURITY IN ONE WAY OR ANOTHER. IF THE PLAN DOES NOT SPECIFICALLY TAKE ACCOUNT OF SOCIAL SECURITY IN THE BENEFIT FORMULA, BUT TAKES ACCOUNT OF IT BY PROVIDING A SOMEWHAT LOWER OVERALL BENEFIT, IT IS SAID TO RECOGNIZE SOCIAL SECURITY IMPLICITLY, OR BE IMPLICITLY INTEGRATED. VERY FEW CORPORATE PLANS ARE OF THIS TYPE. IF THE PLAN BENEFIT, ON THE OTHER HAND, SPECIFICALLY TAKES ACCOUNT OF SOCIAL SECURITY, BY EITHER OFFSETTING A PORTION OF SOCIAL SECURITY PAYMENTS DIRECTLY OR TAKING ACCOUNT OF THEM IN THE BENEFIT FORMULA WITH A LOWER PERCENTAGE APPLIED TO ONE PORTION OF PAY, AND A HIGHER

PERCENTAGE TO ANOTHER, SUCH PLANS ARE SAID TO BE EXPLICITLY INTEGRATED WITH SOCIAL SECURITY. MORE ON THIS LATER, HOWEVER.

NOW LET'S GET BACK TO THE THREE QUESTIONS WE ASKED CONCERNING PAY. FIRST OF ALL, WE MUST DECIDE WHAT THE DEFINITION OF THE COMPENSATION BASE IS. IS THE BENEFIT TO BE BASED ONLY ON BASE SALARY, OR SHOULD THE COMPENSATION BASE INCLUDE OVERTIME, SHOULD IT INCLUDE COMMISSIONS, SHOULD IT INCLUDE BONUSES, ETC?

THE IMPORTANT THING TO KEEP IN MIND WITH REGARD TO ANY ADDITIONS TO BASE SALARY IN THE COMPENSATION BASE USED IS, DO SUCH ADDITIONS REPRESENT A CONTINUING AND REGULAR PART OF THE EMPLOYEES' COMPENSATION, AS OPPOSED TO A SPORADIC, OR OCCASIONAL INCREMENT TO BASE SALARY? IF THE INCREMENT IS CONTINUING AND REGULAR, IT PROBABLY SHOULD BE INCLUDED IN THE COMPENSATION BASE, SINCE IT WILL BE AN IMPORTANT ELEMENT IN CALCULATING A CORRECT REPLACEMENT RATIO. IF, ON THE OTHER HAND, THE INCREMENT IS SPORADIC OR OCCASIONAL, IT SHOULD NOT BE INCLUDED. (IN FACT, IF THE EMPLOYEE HAS SOME CONTROL OVER THE AMOUNT OF THE INCREMENT, AS IS OCCASIONALLY TRUE OF OVERTIME, INCLUDING THE INCREMENT CAN ACTUALLY DISTORT THE INTENDED RETIREMENT BENEFITS, AS IN THE CASE OF A FINAL 3 YEAR AVERAGE SALARY, WHERE AN EMPLOYEE GENERATES UNUSUALLY HIGH AMOUNTS OF OVERTIME DURING HIS FINAL 3 YEARS OF EMPLOYMENT, PRIMARILY TO INCREASE HIS RETIREMENT INCOME). UNDER THE CIVIL SERVICE RETIREMENT SYSTEM, THE COMPENSATION BASE IS ALMOST UNIVERSALLY BASE PAY.

THE SECOND QUESTION WE ASKED REFERRED TO THE BASIS OF COMPENSATION, I.E. CAREER AVERAGE OR FINAL AVERAGE SALARY. CAREER AVERAGE SIMPLY MEANS THAT THE UNIT OF BENEFIT WHICH IS CREDITED DURING ANY YEAR IS BASED UPON THE EMPLOYEE'S COMPENSATION DURING THAT SPECIFIC YEAR (E.G. 1% OF ACTUAL SALARY FOR EACH YEAR OF SERVICE). YEARS AGO, MANY PLANS WERE OF THIS NATURE, BUT THE INCREASES IN THE INFLATIONARY RATE OVER INTERVENING YEARS HAVE CAUSED MOST EMPLOYERS TO MOVE TO FINAL AVERAGE SALARY PLANS, WHERE THE UNIT OF BENEFIT IS BASED UPON SOME FINAL AVERAGE SALARY, IN ORDER TO OVERCOME THE UNDESIRABLE FEATURE OF RETIREMENT BENEFITS WHICH HAD OTHERWISE ALREADY BEEN ERODED BY INFLATION BEFORE THEY EVEN BECAME PAYABLE. (THE FLIP SIDE OF THIS IS THAT CAREER AVERAGE PLANS ARE LESS EXPENSIVE THAN ARE FINAL AVERAGE PAY PLANS AND DURING THE RECENT RECESSION A FEW COMPANIES WITH FINAL AVERAGE PLANS EFFECTIVELY FROZE ACCRUED BENEFITS, AND WENT CAREER AVERAGE FOR FUTURE SERVICE, WITH THE IDEA OF PERIODIC UPDATES IN THE FUTURE...SORT OF A THROWBACK TO CAREER AVERAGE BUT NOT ALL THE WAY, IN ORDER TO REDUCE COSTS).

IF OUR PLAN IS A FINAL AVERAGE SALARY PLAN, WE NOW MUST ASK "WHAT IS THE AVERAGING PERIOD OF COMPENSATION?" IN PAST YEARS, FINAL AVERAGE SALARIED PLANS WHICH WERE DESIGNED TO KEEP THE BENEFIT RELATED TO EARNINGS IN A PERIOD PRIOR TO RETIREMENT IN AN EFFORT TO DEFEAT INFLATION, MIGHT HAVE AVERAGED COMPENSATION OVER THE FINAL 10 YEARS. AS INFLATION INCREASED IN INTENSITY, IT BECAME OBVIOUS THAT AVERAGING SALARY OVER 10 YEARS, EVEN THOUGH WORKING WITH THE FINAL 10

YEARS, STILL CAUSED AN EROSION OF SCHEDULED BENEFITS DUE TO RAPID INFLATION. HENCE, MOST PLANS MOVED TO 5-YEAR AVERAGING. IN THE PAST 5 TO 10 YEARS, WE HAVE SEEN A NUMBER OF PLANS CHANGE TO FINAL 3-YEAR AVERAGE COMPENSATION (ALTHOUGH THE BULK OF PLANS, BY FAR, ARE STILL ON 5 YEAR AVERAGE COMPENSATION). THE CURRENT CIVIL SERVICE RETIREMENT SYSTEM IS A HIGHEST 3-YEAR AVERAGE SALARY PLAN.

JUST TO ILLUSTRATE HOW THESE THREE QUESTIONS RELATING TO PERCENTAGE OF PAY CAN AFFECT THE BENEFIT, AN EMPLOYEE WHO RETIRED AT AGE 65, AFTER 40 YEARS OF SERVICE AND WAS EARNING $40,000 BASE PAY AT RETIREMENT WOULD HAVE A CAREER AVERAGE SALARY OF JUST UNDER $16,000, IF YOU ASSUMED A UNIFORM 6% SALARY PROGRESSION. THIS SAME EMPLOYEE'S FINAL AVERAGE SALARY WOULD RANGE FROM SLIGHTLY OVER $31,000 IF AVERAGED OVER THE FINAL 10 YEARS UP TO JUST UNDER $38,000, IF AVERAGED OVER THE FINAL 3 YEARS. THESE NUMBERS WOULD ALL INCREASE PROPORTIONATELY IF TOTAL COMPENSATION WERE USED IN PLACE OF BASE PAY (SEE TABLE 1).

THE SECOND BROAD CATEGORY OF FORMULAS, AS I MENTIONED, IS FLAT BENEFIT FORMULAS, WHERE THE UNDERLYING PHILOSOPHY IS THAT ONCE SOMEONE HAS BEEN EMPLOYED A MINIMUM NUMBER OF YEARS, RETIREMENT BENEFITS SHOULD NOT BE RELATED TO YEARS OF SERVICE. TYPICALLY, THE BENEFITS MIGHT BE EXPRESSED AS, SAY, 50% OF COMPENSATION ONCE AN EMPLOYEE COMPLETES 25 YEARS OF SERVICE. BENEFITS WOULD BE REDUCED PROPORTIONATELY FOR ANY SERVICE LESS THAN 25 YEARS. INCIDENTALLY THIS TYPE OF PLAN MAY ALSO BE INTEGRATED WITH SOCIAL SECURITY, WHICH TOPIC I WILL DISCUSS LATER.

One other aspect of the benefit formula that I would like to touch on is the pattern of benefit accruals. Although most private plans have the accrual spread evenly over the service period, this does not have to be. If the employer desires to encourage long service or encourage short service, he can alter the accrual rate accordingly. In those instances where he might wish to provide early retirement incentives, the plan might provide a higher accrual rate for the first portion of total service and a lower percentage for the later portion of service; for example, 2% a year for the first 20 years and 1% per year for years thereafter, or alternatively 2% per year for up to 25 years of service, and nothing thereafter. These types of formulas are known as front-loaded.

On the other hand, a plan which encourages longer service might be back-loaded. The Civil Service Retirement System is of this type, and provides for an annual benefit accrual of 1-1/2% for the first 5 years of service, 1-3/4% for the next 5 years, and 2% for all service beyond the first 10 years. I might just note that in order to discourage private employers from back loading their plans so excessively that they tilt them overwhelmingly in favor of longer service employees who might typically be the higher paid, Congress, when it passed ERISA in 1974, incorporated some accrual tests that qualified plans must meet in order to avoid this type of discrimination. I won't go into these tests today except to mention that there are three different tests and a plan must meet one of those tests with regard to benefit accruals.

I WOULD ALSO NOTE THAT SOME PRIVATE PLANS PROVIDE A MINIMUM BENEFIT IN ORDER TO ASSURE A BASIC FLOOR OF PROTECTION. WHAT ABOUT MAXIMUM BENEFITS? A NUMBER OF YEARS AGO THERE GENERALLY WERE NO MAXIMUMS PLACED ON PENSION PLANS, BUT WITH THE PASSAGE OF ERISA IN 1974, CONGRESS SPECIFIED A MAXIMUM LIMIT FOR QUALIFIED PRIVATE PLANS OF THE LESSER OF $75,000 OR 100% OF A PARTICIPANT'S AVERAGE COMPENSATION DURING THE THREE CONSECUTIVE CALENDAR YEARS OF HIGHEST COMPENSATION. THE $75,000 WAS TO BE ADJUSTED AUTOMATICALLY FOR THE COST-OF-LIVING, AND BY 1982, THIS MAXIMUM AMOUNT HAD RISEN TO $136,425.

LEGISLATION DURING THAT YEAR (TEFRA, THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT), IMPOSED A MAXIMUM ANNUAL BENEFIT LIMITATION OF $90,000 ON QUALIFIED DEFINED BENEFIT PLANS UNTIL 1986, AND THE DEFICIT REDUCTION ACT OF 1984 PASSED LAST MONTH BY BOTH HOUSES OF CONGRESS HAS EXTENDED THIS FREEZE UNTIL 1988. AS YOU KNOW, THE CIVIL SERVICE RETIREMENT SYSTEM HAS A MAXIMUM BENEFIT EQUAL TO 80% OF HIGHEST 3 YEAR AVERAGE SALARY.

NOW, LET'S TURN OUR ATTENTION TO SOCIAL SECURITY INTEGRATION. THE CIVIL SERVICE RETIREMENT SYSTEM, FOR NEW FEDERAL EMPLOYEES, NOW FACES THE QUESTION OF WHETHER TO INTEGRATE IMPLICITLY OR EXPLICITLY. IMPLICIT INTEGRATION WOULD ACKNOWLEDGE THE EXISTENCE OF A SEPARATE SOCIAL SECURITY BENEFIT BY PROVIDING A LOWER BENEFIT LEVEL FOR ALL EMPLOYEES THAN THE CURRENT CIVIL SERVICE RETIREMENT SYSTEM BENEFIT LEVEL. THE ADVANTAGE OF IMPLICIT INTEGRATION IS

THAT IT IS SIMPLE, AND EASILY UNDERSTOOD BY EMPLOYEES. THE SIGNIFICANT DISADVANTAGE IS THAT IT FAILS TO ACHIEVE APPROPRIATE REPLACEMENT RATIOS FOR ALL EMPLOYEES UNLESS, OF COURSE, MOST EMPLOYEES ARE AT THE SAME APPROXIMATE PAY LEVEL. THIS IS NOT GENERALLY TRUE IN CORPORATE PLANS, AND IS NOT TRUE IN THE CASE OF CIVIL SERVICE EMPLOYEES. THEREFORE, IT IS QUITE LIKELY THAT ANY REVISIONS WILL EXPLICITLY RECOGNIZE SOCIAL SECURITY, THAT IS, RECOGNIZE THE SOCIAL SECURITY PENSION BENEFIT IN THE CIVIL SERVICE RETIREMENT SYSTEM BENEFIT FORMULA.

THERE ARE THREE APPROACHES TO CHOOSE FROM IN EXPLICITLY INTEGRATING WITH SOCIAL SECURITY. THESE WERE DISCUSSED IN THE THIRD POLICY FORUM OF THIS SERIES IN SOME DETAIL, AND I THEREFORE WILL SIMPLY TOUCH ON THE HIGHLIGHTS HERE TODAY.

THE FIRST METHOD IS TO OFFSET THE ULTIMATE PENSION BENEFIT BY SOME PERCENTAGE OF THE AMOUNT RECEIVED FROM SOCIAL SECURITY. THE IRS HAS ISSUED FAIRLY DETAILED REGULATIONS PRESCRIBING THE MAXIMUM OFFSET PERMITTED. IN VIEW OF THESE REGULATIONS, MOST CORPORATE PLANS UTILIZING THIS APPROACH GENERALLY END UP OFFSETTING 50%-60% OF THE INDIVIDUAL'S SOCIAL SECURITY BENEFIT. THE ADVANTAGES OF OFFSET INTEGRATION ARE THAT IT IS EASILY UNDERSTOOD BY EMPLOYEES AND IT AUTOMATICALLY KEEPS PACE WITH CHANGING LEVELS OF SOCIAL SECURITY FOR SUCCESSIVE GENERATIONS OF RETIREES. THE DISADVANTAGE IS THAT THE EMPLOYEE HAS THE FEELING OF SEEING SOMETHING DEDUCTED FROM HIS PENSION THAT HE FEELS HE HAS PURCHASED (ALTHOUGH, FROM A THEORETICAL VIEWPOINT, THIS IS NOT TRUE).

Let's take a moment to look at an example of offset integration, since it will serve to illustrate the underlying concept of all Social Security integration. First, let's look again at the benefits provided by Social Security. Note that Social Security was specifically designed to replace a higher percentage of income at the lower salary levels than at the higher salary levels. To illustrate this, I've shown replacement ratios for a retiree in 1984 ranging from 50% at $10,000 to 12% at $70,000 (see Table 2).

Note that, in order to provide employees with appropriate replacement ratios, which as I noted earlier, generally range from 50%-80%, depending on pre-retirement salary levels, an employer looking at these Social Security replacement ratios would, ideally, not wish to provide lower paid employees with any benefit, while supplementing higher paid employees Social Security benefits to the extent necessary to attain the 50% replacement ratio objective, i.e., the employer would prefer offsetting 100% of the Social Security Benefit. However, since Social Security benefits are financed by equal employee and employer contributions, the IRS, in a complex Revenue Ruling, limits the permissible Social Security offset.

Let's next consider the actual replacement ratios under a typical private plan which is integrated with Social Security and also complies with IRS regulations. Note that this offset plan provides a tilt in favor of higher paid

EMPLOYEES TO COUNTERACT THE SOCIAL SECURITY TILT IN FAVOR OF LOWER PAID EMPLOYEES (SEE TABLE 3). HOWEVER, WHEN THIS PLAN'S BENEFITS ARE COMBINED WITH SOCIAL SECURITY BENEFITS, THE RESULTING REPLACEMENT RATIOS ARE ACTUALLY QUITE CLOSE TO THE ORIGINAL 50%-80% DESIRED REPLACEMENT RATIOS (SEE TABLE 4).

THE OTHER TWO WAYS THAT THE EMPLOYER CAN EXPLICITLY INTEGRATE PENSION BENEFITS WITH SOCIAL SECURITY BENEFITS ARE BY USING EITHER EXCESS, OR STEP RATE EXCESS INTEGRATION FORMULAS. LET'S DISCUSS THE EXCESS FORMULA BRIEFLY SINCE THE STEP RATE EXCESS FORMULA CAN THEN BE MORE EASILY EXPLAINED. EXCESS PLANS (OFTEN ALSO CALLED "PURE EXCESS" PLANS) SIMPLY PROVIDE NO PENSION BENEFITS FOR EARNINGS BELOW A CERTAIN LEVEL, KNOWN AS THE INTEGRATION LEVEL. BENEFITS ARE INSTEAD BASED ON A PERCENT OF EARNINGS ABOVE THIS INTEGRATION LEVEL. OBVIOUSLY THIS IS TO COUNTERACT THE EFFECTS OF SOCIAL SECURITY, WHICH AS DISCUSSED EARLIER, GIVES MORE CREDIT TO LOWER EARNINGS THAN TO HIGHER EARNINGS (OR IN THE PARLANCE, IS TILTED TOWARD LOWER EARNINGS). THIS LEVEL OF EARNINGS BELOW WHICH NO BENEFITS ARE PROVIDED IS KNOWN AS THE INTEGRATION LEVEL. IN THE SAME REVENUE RULING REFERRED TO EARLIER, THERE ARE RULES COVERING HOW THIS INTEGRATION LEVEL IS DETERMINED, AND THERE ARE ALSO RULES GOVERNING THE INTEGRATION PERCENTAGES THAT ARE PERMITTED. BECAUSE THE TOTAL AMOUNT OF BENEFIT PERMITTED UNDER A PURE EXCESS PLAN IS LIMITED, IT CANNOT BE USED TO ACHIEVE APPROPRIATE REPLACEMENT RATIOS FOR A GROUP WITH A BROAD SALARY DISTRIBUTION, AND IS THEREFORE NOT WIDELY FOUND IN

CORPORATE PLANS, NOR WOULD IT BE APPROPRIATE FOR USE IN THE CIVIL SERVICE RETIREMENT SYSTEM.

THE STEP RATE EXCESS FORMULA IS REALLY NOTHING MORE THAN A VARIATION OF THE PURE EXCESS FORMULA IN THAT A CERTAIN PERCENTAGE OF BENEFIT IS GIVEN BELOW THE INTEGRATION LEVEL AND A HIGHER PERCENTAGE GIVEN ABOVE THE INTEGRATION LEVEL. THE CONCEPT HERE IS SIMILAR TO THE EXCESS PLAN, IN THAT LESSER BENEFITS ARE GIVEN TO THE LOWER PAID BECAUSE OF THE SOCIAL SECURITY TILT IN THEIR FAVOR. HOWEVER, THE TOTAL BENEFITS THAT CAN BE PROVIDED UNDER THIS TYPE OF INTEGRATION DO ENABLE IT TO BE USED IN ACHIEVING MORE APPROPRIATE REPLACEMENT RATIOS FOR GROUPS WITH BROAD SALARY DISTRIBUTIONS.

AS I MENTIONED, SINCE SOCIAL SECURITY INTEGRATION WAS DISCUSSED MORE FULLY IN THE THIRD POLICY FORUM OF THIS SERIES, I AM NOT GOING TO GO INTO ANY MORE DETAILS; HOWEVER, I WOULD SIMPLY NOTE THAT OFFSET INTEGRATION IS THE MOST EFFECTIVE APPROACH IN RECOGNIZING THE SOCIAL SECURITY TILT TOWARD LOWER PAID EMPLOYEES AND THEREFORE IS THE MOST WIDELY USED INTEGRATION APPROACH IN CORPORATE PLANS.

NOW LET ME TURN VERY BRIEFLY TO DEFINED CONTRIBUTION PLANS, SINCE THESE WERE ALSO COVERED IN SOME DETAIL IN THE FIRST POLICY FORUM. THE UNDERLYING AND EXTREMELY IMPORTANT BASIC DIFFERENCE BETWEEN DEFINED CONTRIBUTION AND DEFINED BENEFIT PLANS IS THAT UNDER A DEFINED CONTRIBUTION PLAN, THE EMPLOYER DOES NOT UNDERTAKE TO PROVIDE RETIREMENT BENEFITS

OF ANY PRE-DETERMINED AMOUNT (AS HE DOES IN THE CASE OF DEFINED BENEFIT PLANS). INSTEAD, THE EMPLOYER'S CONTRIBUTION IS DEFINED, AS OPPOSED TO THE BENEFIT BEING DEFINED. THE EMPLOYER DOES UNDERTAKE A FIXED OR DEFINED CONTRIBUTION COMMITMENT (GENERALLY A PERCENTAGE OF SALARY) AND FUNDS, CONSISTING OF THESE CONTRIBUTIONS, ARE ALLOCATED INDIVIDUALLY TO EMPLOYEES TO ACCUMULATE AT WHATEVER INVESTMENT RETURN MIGHT ACCRUE FROM THE INVESTMENT OF THESE FUNDS.

AT RETIREMENT, THE ACCUMULATED CONTRIBUTIONS, WITH INVESTMENT RETURN, ARE MADE AVAILABLE TO THE EMPLOYEE; THIS AMOUNT MAY BE MADE AVAILABLE AS A LUMP SUM, OR APPLIED AT THE THEN-CURRENT ANNUITY PURCHASE RATES TO PROVIDE WHATEVER AMOUNT OF RETIREMENT INCOME THE LUMP SUM WILL PURCHASE. NOTE THAT IN THE DEFINED CONTRIBUTION PLAN THE TOTAL INVESTMENT RISK FALLS ON THE EMPLOYEE, AS OPPOSED TO DEFINED BENEFIT PLANS, WHERE THE EMPLOYER BEARS THE INVESTMENT RISK.

PROBABLY THE SINGLE BIGGEST DISADVANTAGE OF DEFINED CONTRIBUTION PLANS IS THAT THEY DO NOT PRODUCE AN APPROPRIATE REPLACEMENT RATIO FOR ALL EMPLOYEES, SINCE THE AMOUNT ACCUMULATED AT RETIREMENT DEPENDS ON THE PERIOD OF ACCUMULATION AND THE INVESTMENT EARNINGS. ANOTHER DISADVANTAGE IS THAT IT IS DIFFICULT TO ESTIMATE THE RETIREMENT BENEFIT WITH ANY DEGREE OF PRECISION, WHICH MAKES RETIREMENT PLANNING SOMEWHAT MORE SPECULATIVE THAN WITH A DEFINED BENEFIT PLAN.

THE BIGGEST ADVANTAGE OF DEFINED CONTRIBUTION PLANS, ASIDE FROM THEIR SIMPLICITY, IS THAT IF A PERSON CHANGES JOBS OFTEN, HE WILL LIKELY BE BETTER OFF UNDER A DEFINED CONTRIBUTION PLAN THAN UNDER A DEFINED BENEFIT PLAN SINCE VESTING GENERALLY OCCURS EARLIER IN DEFINED CONTRIBUTION PLANS. FOR EXAMPLE, CURRENTLY SOMEONE IN PRIVATE INDUSTRY COULD HAVE JOBS WITH FOUR DIFFERENT EMPLOYERS, SERVE 9 YEARS WITH EACH, AND END UP WITH NO BENEFITS IF THE VESTING WERE 100% AFTER 10 YEARS OF SERVICE IN EACH OF THOSE PLANS. THIS TYPE OF SITUATION WOULD NOT NORMALLY ARISE IF ALL EMPLOYERS HAD DEFINED CONTRIBUTION PLANS. HOWEVER, WE SHOULD KEEP IN MIND THAT WE ARE TALKING ABOUT A CIVIL SERVICE RETIREMENT PLAN WHICH IS PRIMARILY DESIGNED FOR CAREER EMPLOYEES, AND WHICH CURRENTLY VESTS 100% AFTER ONLY 5 YEARS OF SERVICE.

WITH REGARD TO SOME OF THE POINTS MENTIONED EARLIER REGARDING BENEFIT FORMULAS, AS THEY PERTAIN TO DEFINED CONTRIBUTION PLANS, LET ME SIMPLY SAY THAT YOU DON'T FIND ANY BACK-LOADING OR FRONT-LOADING IN DEFINED CONTRIBUTION PLANS, AND THE OFFSET SOCIAL SECURITY INTEGRATION APPROACH IS NOT PERMITTED; HOWEVER, BOTH THE EXCESS AND STEP RATE INTEGRATION APPROACHES ARE. AS AN EXAMPLE, THIS YEAR THE EMPLOYER CAN CONTRIBUTE ZERO BELOW, AND 5.7% ABOVE, THE INTEGRATION WAGE BASE IN A DEFINED CONTRIBUTION PLAN.

ONE OTHER DIFFERENCE IS THAT IN DEFINED CONTRIBUTION PLANS, WHEN DEFINING THE BENEFIT FORMULA, THE NORMAL RETIREMENT AGE IS OF CONSIDERABLY LESS SIGNIFICANCE THAN IN THE CASE OF A DEFINED BENEFIT PLAN.

FINALLY, I WAS ASKED TO NOTE BRIEFLY THE EFFECT OF BENEFIT FORMULAS ON A COMBINATION OF THE TWO PLANS. IN THE PRIVATE SECTOR, BY FAR THE MAJORITY OF LARGER EMPLOYERS HAVE UTILIZED DEFINED BENEFIT PENSION PLANS INTEGRATED WITH SOCIAL SECURITY AS THEIR BASIC RETIREMENT SCHEME IN ORDER TO PROVIDE THE DESIRED REPLACEMENT RATIOS FOR THEIR EMPLOYEES. THEY HAVE THEN SUPPLEMENTED THESE BASIC DEFINED BENEFIT PLANS WITH DEFINED CONTRIBUTION PLANS, GENERALLY OF THE SO-CALLED THRIFT PLAN VARIETY, WHERE THE EMPLOYER MATCHES SOME PERCENTAGE OF EMPLOYEE CONTRIBUTIONS, BOTH MADE ON A DEFINED CONTRIBUTION BASIS.

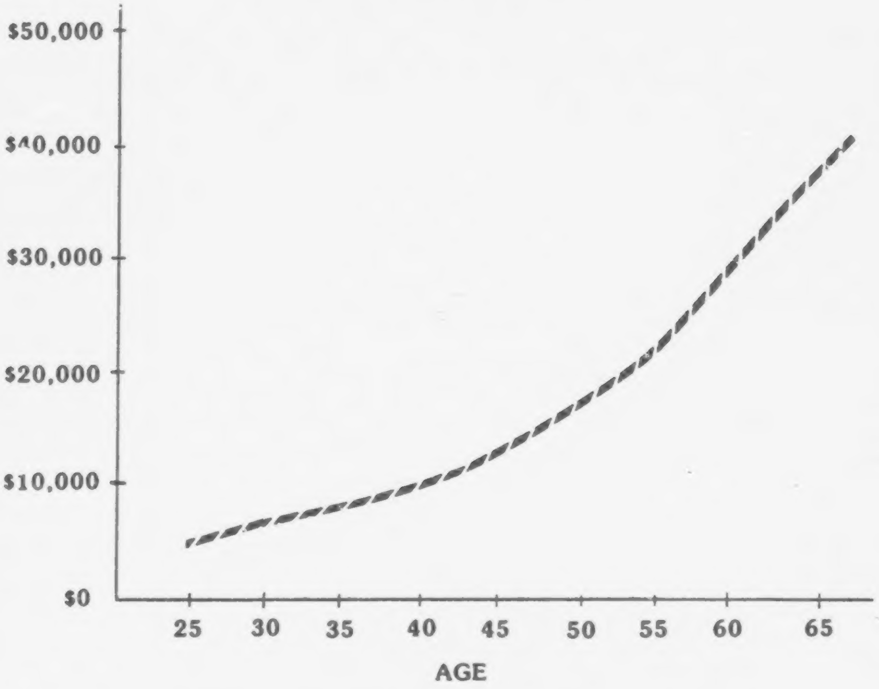
THIS APPROACH STRIKES ME AS EMINENTLY WORTHY OF FURTHER INVESTIGATION FOR CIVIL SERVICE EMPLOYEES, SINCE I DO FEEL THAT THE POSITIVE FEATURES OF A DEFINED BENEFIT PLAN, MOST SPECIFICALLY, THAT OF BEING ABLE TO DESIGN A PLAN WHICH WILL PROVIDE APPROPRIATE REPLACEMENT RATIOS IS OF PARAMOUNT IMPORTANCE IN ANY WELL-DESIGNED RETIREMENT SCHEME...AND I DO THINK CIVIL SERVICE EMPLOYEES DESERVE A WELL-DESIGNED RETIREMENT PLAN. THE ADVANTAGES OF A DEFINED CONTRIBUTION PLAN, WHICH COULD BE SUPPLEMENTAL, WOULD BE TO THEN ENCOURAGE EMPLOYEE SAVINGS, AND ALSO COULD BE CONSIDERED AS A WAY TO PROVIDE SUPPLEMENTS TO THE BASIC DEFINED BENEFIT PLAN (INSTEAD OF THE CURRENT AUTOMATICALLY INDEXED COST OF LIVING INCREASE), TO ACT AS A HEDGE AGAINST FUTURE INFLATION AFTER RETIREMENT...BUT THEN, COST OF LIVING ADJUSTMENTS IS ANOTHER WHOLE TOPIC AND IS THE SUBJECT OF OUR LAST SPEAKER TODAY.

As you will note from the discussions which follow on Retirement Ages, Death and Disability Benefits, Vesting, and Cost of Living Adjustments, many of the various aspects of Plan Design are interrelated, and directly affect the cost.

Hopefully, this final forum will provide you with additional insight as to the relative importance of each of these factors, both from the benefit design aspect, and as well with regard to their ultimate impact on plan costs.

TABLE 1

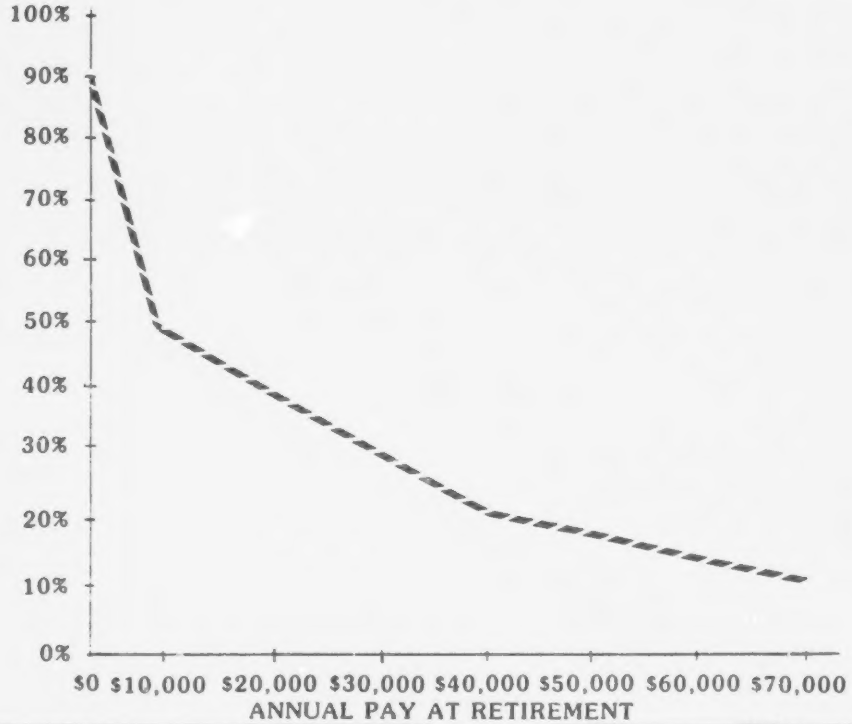
EMPLOYEE HIRED AT AGE 25
RETIRES AT AGE 65
EARNING $40,000 SALARY



CAREER AVERAGE SALARY	$15,949
FINAL AVERAGE SALARY	
3 YEARS	$37,779
5 YEARS	$35,721
10 YEARS	$31,207

TABLE 2

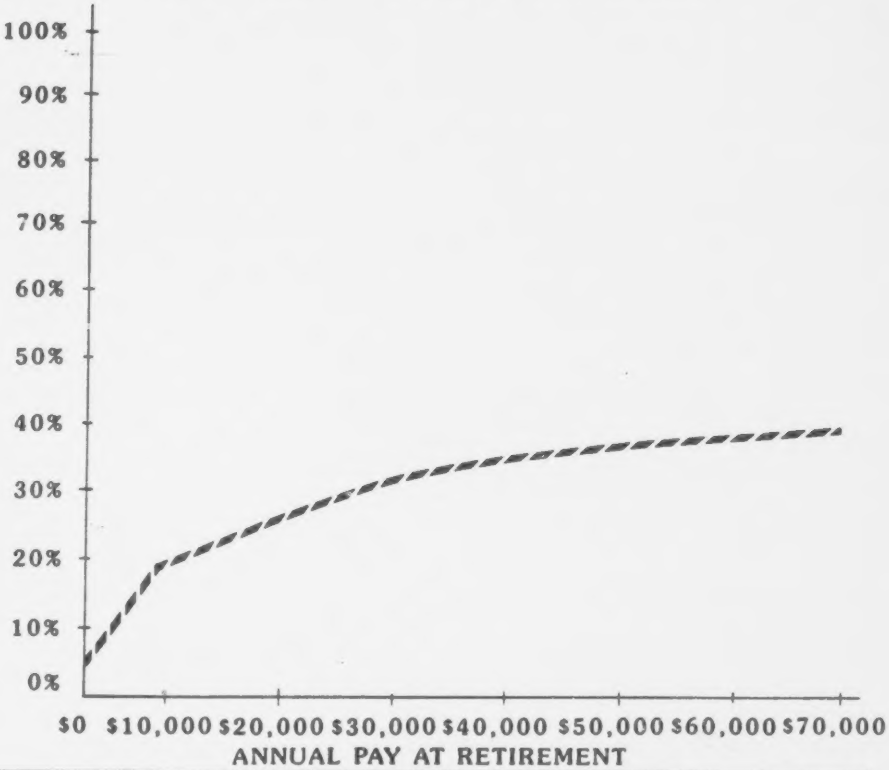
SOCIAL SECURITY REPLACEMENT RATIOS



SALARY AT AGE 65	ANNUAL PRIMARY SOCIAL SECURITY BENEFIT	REPLACEMENT RATIOS
$10,000	$5,028	50%
$30,000	$8,364	28%
$50,000	$8,436	17%

TABLE 3

PENSION REPLACEMENT RATIOS

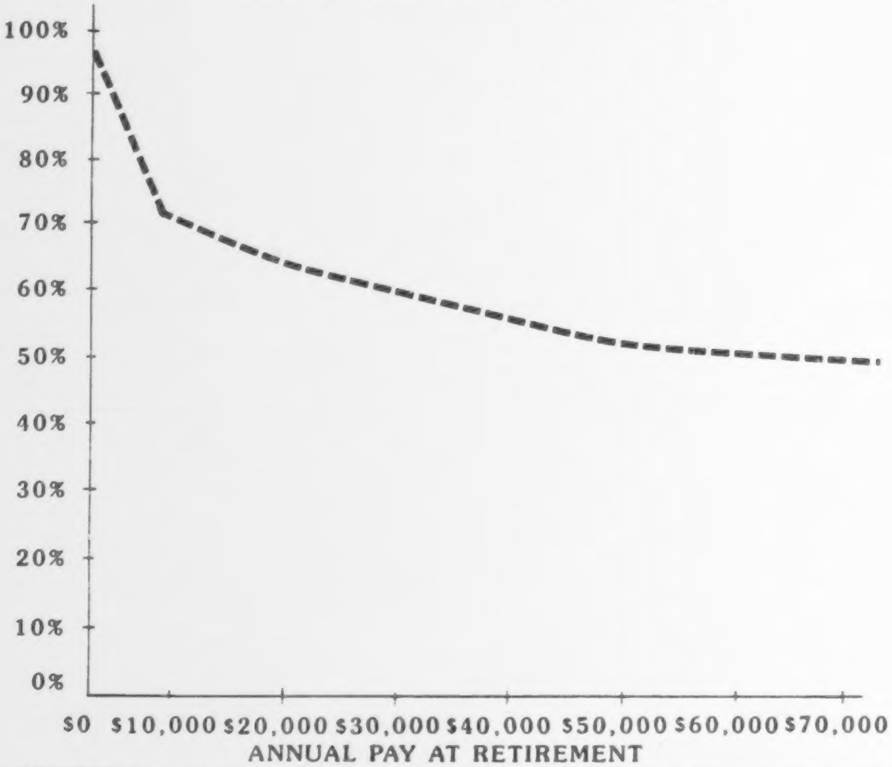


SALARY AT AGE 65	ANNUAL PENSION BENEFIT*	REPLACEMENT RATIOS
$10,000	$1,930	19%
$30,000	$9,151	31%
$50,000	$18,004	36%

*50% OF FINAL AVERAGE SALARY MINUS 50% OF SOCIAL SECURITY BENEFIT

TABLE 4

TOTAL REPLACEMENT RATIOS



SALARY AT AGE 65	TOTAL RETIREMENT BENEFIT	REPLACEMENT RATIOS
$10,000	$6,958	70%
$30,000	$17,515	58%
$50,000	$26,440	53%

RETIREMENT AGE AND PROPOSED NEW CIVIL SERVICE RETIREMENT PROGRAM

By William C. Greenough*

May I first enthusiastically commend the idea of these forums, with their greater informality and opportunity for discussion and interchange among experts and thoughtful laymen.

In discussing retirement ages, I do not plan to present data. Your committees have access to exhaustive data as to retirement ages used in various employments, and the ages at which people actually retire under Civil Service, Social Security, and other retirement plans. Our job here is to contemplate what ought to be retirement ages for the next 20 to 40 years for new employees under Civil Service, and to work toward that objective.

The ultimate purpose of a retirement plan is to make it feasible for employees to retire in a socially acceptable manner at an appropriate age.

But this simple statement has very broad ramifications. The full objective is to achieve a productive workforce--best achieved through fair treatment of the individual workers covered by the plan, the employer, and society.

A major problem in discussing retirement ages under a proposed new Civil Service Retirement Program is the broad scope of Federal employment, the many kinds of skills, interests, experience, attitudes, vigor, and ability needed, and the competition for productive talent with private enterprise, non-profit employment, and other governmental work. Another problem is that many people approach the question of retirement age from opposite perspectives. The first is personal, introspective. Some people want to get out as early as possible--perhaps they don't like the jobs they are in, or they want a different second career, or to enjoy leisure. Others love their jobs, or are workaholics and never want to retire, or think they never grow old. Personally, I can proclaim: "At age 69 I'm as good as I ever was at age 29, or 39, or 49." But even my wife has a better memory than that. And attitudes will differ according to the physical and mental requirements and stress of a job, the attractiveness, the pay, and fringe benefits. The second is "objective," that is, "when should the other fellow retire?" "Most people are slipping by the time they are about 65 and should be retired." Or, "People age at very different rates -- there should be objective tests as to physiological age." Or, "The job requires youth and strength, so should carry a low retirement age." Or, "People ought to be allowed to work as long as they want to."

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*Presented by William C. Greenough, Ph.D., Retired Chairman and CEO, Teachers Insurance and Annuity Association of America, College Retirement Equities Fund, July 10, 1984, at Policy Forum, Committee on Governmental Affairs, United States Senate.

Almost all of this supports the idea of a flexible retirement age for Federal service.

During the last hundred years both our laws and our social attitudes with respect to retirement age have been increasingly skewed toward employer attitudes. Most pension plans had a compulsory retirement age, usually age 65 in private enterprise, without flexibility. Two major demographic trends gathered force during the century. The first was a trend toward more and more men (it was a century of male employment) withdrawing from the labor force at age sixty-five, or even earlier. The hundred years opened with perhaps 70% of employed people beyond age 65 staying in the labor force;

it is closing with perhaps less than 15% staying in the regular force. Precisely halfway through the hundred years Social Security was developed, partially to get the old people out of competition with the younger. At the same time that this trend was occurring, far more people--both proportionately and absolutely, were living beyond the normal retirement ages. So the number of years spent in retirement has been [illegible]reasing dramatically. The retirement age in the present Civil Service Retirement Program can be considered an extreme product of this history.* In fact, the "age 55 with no reduction in benefits after 30 years of service" will undoubtedly prove to be the nadir of the trends of the last century.

It is really great good luck that the matter of retirement ages in Federal employment must be reconsidered at this time. Monumental labor market and attitude shifts are already occurring. A major change is that just last month we reached the point at which one-half of working-age women are employed in America. A significant social change has been in attitudes toward retirement. The ADEA suddenly outlawed compulsory retirement ages under 70 in most of American employment. More and more states are uncapping retirement ages. So far, workers have not caught up with ADEA--they're still retiring earlier and earlier. But I believe the time has come when demographic, social, and economic factors will reverse the trend. Let me allude to some of the primary factors.

The Cost Lever:

For pensions retirement age is the most important single cost factor. It determines whether a pension will be paid for a couple (wife, about two years younger) on the average for about 22 years (age 70 retirement), 26 years (age 65 retirement), or 34 years (retirement at age 55). All of you as participants in this forum know the figures--to quote only one, it costs about twice as much to retire at 55 as at 65. Practically all of the studies on governmental retirement plans--the President's Commission on Pension Policy, the GAO, the Committee for Economic Development, The Grace Commission, various advisory commissions, and these seminars, have placed heavy emphasis on the high cost of early retirement without actuarial reduction, and have recommended change.

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*A National Bureau of Economic Research Study shows that over half of Federal employees retire before age 60 but only 7% of private employees do.

Getting The Federal Work Done:

It is now pretty generally agreed that the very early retirements taken by so many long-term Federal employees are costly not only in financial terms but also in terms of getting the government's work done, and perhaps to the feeling of usefulness of many individuals as well. Full-benefit retirements at early ages lead to a loss of experience and expertise that is difficult to replace. Turnover is expensive in itself. And the government, unlike the private sector, is losing seven to ten years of productive service between age 55 and 62 to 65. So from the standpoint of addressing the personnel needs of the Federal government, a higher retirement age would seem indicated as advantageous to individuals, the government, and the taxpayer interests.

Distribution of Lifetime Income:

Government compensation has not always followed the most effective or the most rational bases. Failure to take total compensation into consideration helped to lead to this. For many years, especially in the Great Depression, government employment was probably substantially underpaid. Recompense was made, as so many studies show, by overly generous retirement arrangements, with the cost deferred. This meant that the government was forcing on its employees a lifetime distribution of their total earnings that may not have been in their best interests. In recent years it has resulted in heavy retirements from Federal service at age 55 with 30 years of service, since there is little financial gain from staying beyond that point. Wage compression at top governmental levels and pension escalation has exacerbated the situation. This heaping up of salary income below certain ages, and annuity income beyond those same low ages, does not necessarily treat employees or the government best. A system providing appropriate pay for a longer period of employment, followed by good retirement income for a reasonable period, would seem to be much better.

Longevity:

Otto von Bismarck got a very good press a hundred years ago by putting in retirement benefits at age 70 in Germany (later moved to 65) for the very small number of people who lived to that age and then actually retired. A hundred years later, 28 million Americans are living beyond age 65, and the great majority of them are retiring. Hopefully improving longevity means not only longer life but longer life in good health, which once again suggests later retirements instead of earlier.

Multiple Wage Earners In Family:

A vast social change in the opposite direction in very recent years has been the number of women in the labor force, and of multiple-wage earners in the family. This factor alone means that many people can, if they wish, retire earlier since two incomes are supporting retirement arrangements instead of only one.

Youthful Employments:

During this century it has been assumed that the military, police and firemen, intelligence, and such occupations are "hazardous," and deserved very early retirement. This probably does not make much sense any more.

An increasing number of military and other such jobs call for sophisticated mechanical and electronics knowledge and ability, and other refined information. It is true that these employments may well be considered "youthful employments" on the whole. But to act as if such employees are through, are washed up, at age 38-42, and to provide generous retirement benefits for the rest of their lives is, well, a stupid way to handle it. It would be much better to provide good salaries during employment, good retirement benefits starting at age 65, and in between shift to different duties as age advances, or provide generous relocation, retraining, reeducation, and other such grants upon shifting employment.

Flexible Work Arrangements:

Perhaps the Federal Government has an especially challenging opportunity to point the way for employment in America. It has already eliminated mandatory retirement for its own employees, but has made little attempt to change its own job structure. Job patterns are incredibly frozen--nine to five, five days a week, fifty weeks a year, or whatever the particular pattern is. Seniority, union rules, employer regulation, all prevent flexibility. Under such rigidity of course people burn out, get bored, get fed up. Perhaps the Federal Government should lead us toward flexible work arrangements through restructuring jobs for people above certain ages. This could include tapering off, shift to part-time or flexible hours, retraining, different work assignments above age 45, 55, 60, modem connections to home computers, and perhaps even a coming to grips with tapering off of earnings as well as duties. This is not an easy area in which governments can innovate. But as the opportunity to work gets pushed up and up to higher ages under ADEA, etc., changes must be introduced.

Later Retirement Ages:

Practically all of the factors suggest, for the coming 20 to 50 years, a higher and more flexible retirement age for participants in the new Federal Civil Service Retirement Plan. I believe this will be in the interest of the employees, the Federal Government, and society. I believe it will be in the main stream of development of employment patterns, utilization of the skills of older workers, and the social thrust as indicated by ADEA and trends in private retirement ages. And it fits with the demographics of baby booms, dependency ratios, and financing of retirements.

This conclusion is consistent with a preponderance of current recommendations on retirement ages. References would include a number of studies by the President's Commission on Pension Policy, the National Bureau of Economic Research, the Aspen Institute's Quiet Crisis of Public Pension Plans, the ADEA itself, discussions before these Committee Forums, testimony in Congress, various business group recommendations, and Social Security advisory committees. The concurrence is substantial.

One quote can summarize much of the foregoing. The Committee for Economic Development, in its Reforming Retirement Policies, published in the Fall of 1981, said (page 45):

> "It is time for both employers and employees to reconsider their attitudes toward early retirement. Elimination of full-benefit or heavily subsidized retirement at early ages and gradual upward movement of normal retirement ages would help to reverse the current trend toward earlier retirement. Worries about the inroads made by inflation during long periods of retirement also seem to be giving workers second thoughts about early retirement. A shift toward

> later retirement would enable employer and employee contributions to employer pension plans to raise the general level of annual retirement income to be received at normal retirement ages. But employment patterns will also have to shift if the traditional retirement age rises. Just as the American economy has been able to accommodate, and benefit from, an enormous increase in the employment of women, it can also benefit from an increase in the employment of people over age 60 or even 65. This will require more flexible work assignments, including part-time, temporary, flexible-hour, and seasonal work arrangements and job sharing with younger part-time workers."
>
> ... (The CED) "also believes that government-employer plans have misused early retirement provisions at heavy expense to taxpayers, frequently deferring that expense to future generations of taxpayers. We believe early retirement under all public plans should generally be at actuarially reduced benefits."

Just as employers must become more flexible in work arrangements, employees must take responsibility on themselves to avoid physical and intellectual obsolescence if they are to be ready to shift job assignments and patterns at older ages.

Conclusion:

If this forum in 1984 were taking up the question of retirement ages without any historical background at all, I would hazard a guess that it would recommend a normal retirement age for civil service of somewhere between age 68 and 72. This age would fit with demographic facts, with improvements in longevity, with the social philosophy of ADEA, with the realities of governmental employment, and with financing practicalities. But while we should not be a victim of our history, we do need to take account of it. Hence, perhaps a more acceptable arrangement would be to make no change in retirement age for present members of the Retirement System, and to choose, for new members, age 65 as normal retirement age, moving upward in tandem with Social Security.

Coordination Between Plan Retirement Age and Plan Design:

One can't really discuss retirement ages without also briefly discussing plan design.

In order to achieve the objectives suggested for the future, a three-layer plan like the ones under primary discussion in these seminars would seem to be fair, flexible, useful, and appropriate, even if a bit complex. The required parts of the three plans could be designed to provide, for new federal employees, the appropriate level of benefits at 65, which would be considered the normal retirement age. There would be no restrictions on when employees could start their benefits, once vesting occurred. For retirements below the normal age, all benefits would be actuarially equivalent to the age 65 benefit. For retirements after that age, full accruals of benefits would be provided under the defined contribution component; no additional accruals would be provided under the defined benefit portion, and the social security portion would follow the standard social security formulas. This pattern would give ample incentive for people who wanted to work to continue after age 65.

Recommendations:

Thus, the retirement ages and benefit plans could look generally like the following, with any specific details open for discussion:

1. Social Security would be the first level of benefits, with its early retirement age of 62, its normal age of

65, and with a gradual upward movement of the retirement ages under the 1983 Social Security Act.

2. A second layer of Federal Civil Service Retirement benefit would be provided by a modest defined benefit plan paid for by employer contributions only. Full formula benefits would be available at normal retirement age of 65, reflecting all years of service. Benefits would be actuarially reduced for early retirement. There would be no accrual of benefits above age 65, except for increases reflecting salary changes.
3. The third layer would be a defined contribution plan paid for by employer and employee contributions, designed to bring benefits up to the appropriate target level at age 65. Employer contributions would cease at age 65.

Voluntary Supplements:

With the flexible retirement ages recommended above, flexibility should also be permitted in retirement savings. The defined contribution plan provided above is an excellent mechanism for this. It can allow an employee maximum opportunity to make his own decisions as to allocating part of his lifetime earnings between preretirement and postretirement income. If he wishes to retire quite early, he would make maximum contributions to the voluntary part of the plan. If he wished to retire later on a generous income, he would do the same. If he wished to retire earlier or later but with less generous retirement income, he would make little or no voluntary contributions.

A specific suggestion would be a voluntary plan with the government matching, one for two, the amount saved by the individual, up to a government maximum contribution of three percent of salary but no limit on employee contributions.

One additional thing is needed. Federal employees should have the ability to defer taxes on both their required and their voluntary annuity contributions up to the same limit as available to certain private employees.

I believe this is the direction in which the discussions as to a Civil Service Retirement Plan for new employees after January 1st, 1984, are moving. It allows all present employees to continue on to their eventual retirement without change in the rules of the game. (By the way, careful consideration should be given to allowing all persons under, say, age 45 to choose either to stay in the present Civil Service Plan or shift to the new one.) And it provides for all new employees a very different but much more currently appropriate plan with maximum flexibility, as is socially required now, both in their choice of a retirement date and in their level of savings for retirement income.

Retirement Age Recommendations:

No Change for present civil service employees.

For New Employees:

1. Normal retirement with full benefits at age 65, moving upward in tandem with Social Security.
2. For retirement before age 65, actuarially reduced benefits that can start at any age after vesting occurs.
3. For retirement after age 65, regular Social Security increases, no further benefit increases except those related to salary increases for the defined benefit portion, and regular actuarial increases without any further employer contributions for the defined contribution plan.

William C. Greenough
June, 1984

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SOME FACTORS TO CONSIDER IN DESIGNING EMPLOYER-SPONSORED DEATH AND DISABILITY BENEFITS

by

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Presented at

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Introduction

Currently, the federal government provides a substantial part of survivor income protection and all disability income protection for federal employees through the Federal Civil Service Retirement System (FCSRS).* In a 1980 study for New York State, Mercer determined that approximately 80% of the value of all employee benefits covering federal employees is provided through FCSRS. This is not unusual in the public sector; most state and local governments also rely on the pension plan as a major source for non-retirement cash benefits -- particularly death and long-term disability benefits.

In the private sector, less emphasis has been placed on the pension plan for providing death and disability income protection. Private employers typically offer substantial death benefit protection to their employees through group term life insurance plans, supplemented by pension plan benefits of one form or another. Similarly, long-term disability protection is commonly provided through long-term disability income (LTD) plans that are established outside of an employer's pension plan. In the public sector, separate LTD plans are rare; disability benefits usually are provided through the employer's pension plan.

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* By death (survivor) benefits, I mean benefits paid to survivors of employees who die during active employment and survivors of retirees who die in the course of receiving pension plan benefits. When I refer to disability benefits, I am speaking of benefits paid to employees who become permanently and totally disabled and qualify for long-term disability benefits from Social Security and/or employer-sponsored disability income arrangements. Short-term disability benefits, also available through employer-provided plans and in some states through state-sponsored short-term disability programs, are not being considered in this discussion.

William M. Mercer-Meidinger, Incorporated

The U.S. Senate Committee on Governmental Affairs has asked me to discuss some of the major factors that should be considered in designing death and disability benefits for federal employees. In my view, these considerations should be no different than the criteria other employers would use in designing thoughtful death and disability benefit protection for their employees. Cost aside, the design of these benefits should be based upon:

- established employer objectives; and
- careful consideration of all possible sources of death and disability income protection.

My presentation will discuss a framework for designing death and disability benefits. This discussion is not meant to be exhaustive or technical, and does not intend to cover all sources of death and disability benefits.* It is designed only to be a basic introduction to this complex area.

Death Benefits

1. Setting Objectives

The most fundamental step in designing any employee benefit plan is for an employer to identify specific objectives for providing a particular benefit. Some of the questions that should be raised in determining the appropriate design of death benefits are as follows:

- What is the purpose of providing death benefits to federal employees:

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* For example, this presentation does not discuss the benefits provided by workers' compensation for work-related death and disability, even though these benefits should be considered in designing supplemental employer-sponsored benefits.

- To provide a continuing stream of income for survivors so that they can preserve the level of earnings prior to an employee's death;
- To provide a lump-sum payment that may tide over the family for a specific period of time; or
- To provide minimal benefits for burial expenses, etc?

- Should benefits be provided to survivors of retirees as well as to survivors of active workers?

- Should employees be required to work a minimum period of time in order for survivors to qualify for death benefits? If so, should the service requirement differ for deaths due to occupational and non-occupational causes?

- Who should be considered eligible for these benefits: a surviving spouse, surviving children, surviving parents, or anyone designated by the employee as beneficiary?

- Should married and single employees have the same level of benefits available to them?

- Can benefits be provided in a more tax-efficient manner in one form than in another?

- Should benefits be designed to dovetail other sources of employer-provided death benefits, including those payable under Social Security and workers' compensation?

- What can be learned from the current design of death benefits for federal employees?

  - Are there any gaps or duplications in benefits?

  - Are all groups of employees being covered equally (e.g., single and married, young, middle-aged and older employees)?

These are only a few of the key questions that need to be raised in setting objectives for the design of death benefits. They address benefit levels, benefit eligibility, equity in entitlement to benefits, and tax treatment of benefits. I will cover each of these areas briefly as I review the types of death benefits available from Social Security, pension plans, and group term life insurance plans.

2. Sources of Death Benefits

- Social Security: Effective January 1, 1984 all new federal employees will be covered by Social Security, as required by the Social Security Amendments of 1983. Covered employees currently pay 6.7% of their salaries in Social Security taxes up to $37,800 and the federal government pays another 7.0% up to this salary level for each covered employee.

Social Security survivor benefits are important and should be considered the basic level of death benefit protection for federal employees. All other death benefits offered to federal employees through a pension plan, life insurance or any other arrangement should be considered supplemental to Social Security survivor benefits.

There are several types of benefits that may be payable under Social Security when a covered worker dies. Some of these benefits require a deceased worker to have been "currently insured;" others require the person to have been "fully insured" as well. To be currently insured, a person needs six quarters of coverage during the last 13 quarters ending with the quarter in which the person dies. To be fully insured, a person must have between six and 40 quarters of coverage depending upon when the person was born and when the person dies.

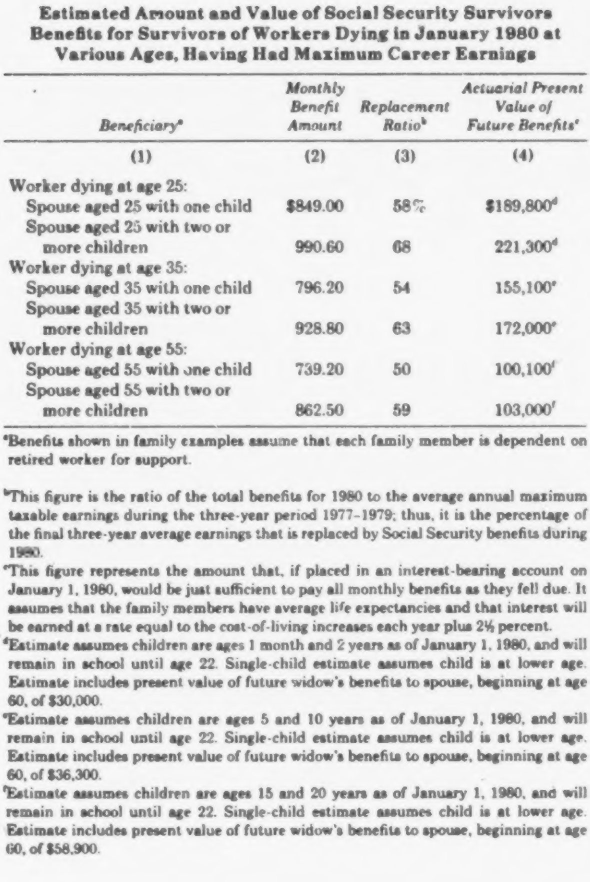
In addition to the lump sum $255 benefit payable to a surviving spouse, monthly Social Security survivor benefits can be paid under a variety of circumstances. For example, benefits can be payable to:

- a spouse caring for an eligible child;
- a divorced spouse caring for an eligible child;
- an eligible child;
- a spouse aged 60 or older (50 or older, if completely disabled);

- a divorced wife aged 60 or older (50 or older, if completely disabled) if the marriage lasted at least 10 years; or
- dependent parents aged 62 or older.

Benefits are tax-free, except for survivors who have substantial incomes. Beginning in 1984 a portion of Social Security benefits will be subject to federal income tax when a taxpayer's earnings exceeds the base amount of $25,000 for single taxpayers and $32,000 for married taxpayers filing joint returns.

The value of death benefits provided by Social Security is not generally recognized by the public. The value of Social Security survivor benefits can range from $255 to $200,000 or more, depending upon individual circumstances. Several examples are shown in the following table excerpted from The Coming Revolution in Social Security, by A. Haeworth Robertson. The table presents numerical examples of estimated monthly Social Security death benefits and the actuarial present value of future benefits to survivors of workers dying in January 1980 in selected situations. While the dollar amounts shown here have changed somewhat since these examples were developed, the levels of income replacement have remained approximately the same.



Estimated Amount and Value of Social Security Survivors Benefits for Survivors of Workers Dying in January 1980 at Various Ages, Having Had Maximum Career Earnings

Beneficiary[a]	*Monthly Benefit Amount*	*Replacement Ratio*[b]	*Actuarial Present Value of Future Benefits*[c]
(1)	(2)	(3)	(4)
Worker dying at age 25:			
Spouse aged 25 with one child	$849.00	58%	$189,800[d]
Spouse aged 25 with two or more children	990.60	68	221,300[d]
Worker dying at age 35:			
Spouse aged 35 with one child	796.20	54	155,100[e]
Spouse aged 35 with two or more children	928.80	63	172,000[e]
Worker dying at age 55:			
Spouse aged 55 with one child	739.20	50	100,100[f]
Spouse aged 55 with two or more children	862.50	59	103,000[f]

[a] Benefits shown in family examples assume that each family member is dependent on retired worker for support.

[b] This figure is the ratio of the total benefits for 1980 to the average annual maximum taxable earnings during the three-year period 1977–1979; thus, it is the percentage of the final three-year average earnings that is replaced by Social Security benefits during 1980.

[c] This figure represents the amount that, if placed in an interest-bearing account on January 1, 1980, would be just sufficient to pay all monthly benefits as they fell due. It assumes that the family members have average life expectancies and that interest will be earned at a rate equal to the cost-of-living increases each year plus 2½ percent.

[d] Estimate assumes children are ages 1 month and 2 years as of January 1, 1980, and will remain in school until age 22. Single-child estimate assumes child is at lower age. Estimate includes present value of future widow's benefits to spouse, beginning at age 60, of $30,000.

[e] Estimate assumes children are ages 5 and 10 years as of January 1, 1980, and will remain in school until age 22. Single-child estimate assumes child is at lower age. Estimate includes present value of future widow's benefits to spouse, beginning at age 60, of $36,300.

[f] Estimate assumes children are ages 15 and 20 years as of January 1, 1980, and will remain in school until age 22. Single-child estimate assumes child is at lower age. Estimate includes present value of future widow's benefits to spouse, beginning at age 60, of $58,900.

Source: The Coming Revolution in Social Security, by A. Haeworth Robertson
(Reston, Va.: Reston Publishing Co., 1981), p. 215.

As this table illustrates, Social Security can be a significant source of death benefits for workers in covered employment, a source that the federal government should consider carefully in determining the appropriate design of supplemental survivor benefits for federal employees who are covered by Social Security.

- Pension Plans: Generally, public and private pension plans provide survivors who meet certain eligibility requirements with some form of death benefit. In the private sector, benefits are limited by IRS plan qualification requirements; the level of death benefits must be incidental to the primary purpose of the pension plan, which is to provide post-retirement income to plan participants. (Technically, this limitation applies to public plans as well, but this and other plan qualification requirements have not been enforced in the public sector.)

The Employee Retirement Income Security Act of 1974 (ERISA) also sets specific requirements that qualified private pension plans must meet in providing death benefits. First, if the plan offers an early retirement benefit, it must give plan participants the opportunity to elect an early survivor annuity. This benefit would be payable to a surviving spouse if the worker dies after reaching early retirement age but before reaching actual retirement. The benefit must equal at least one half of the worker's accrued benefit at the time of death. ERISA also requires that pension benefits for married employees must be paid as a qualified joint and survivor annuity unless the employee elects to receive the retirement benefit in another form. The joint and survivor annuity gives a retired worker a pension benefit which would be continued at the same amount or at a lower amount to the retiree's surviving spouse. In a contributory pension plan, ERISA also requires that the employee's beneficiary receive a refund of employee contributions plus interest thereon that has not been paid out in pension plan benefits.

Even though these ERISA requirements do not apply to federal pension plans, Congress may want to consider the appropriateness of incorporating them into a newly designed FCSRS.

Pre-retirement death benefits that are offered by (defined benefit) pension plans include the following:

- Monthly pension equal to a percentage of what the deceased employee would have received had that person retired on the date of death.

- Lump-sum payment based on the value of the deceased employee's accrued pension up to the date of death.

- Lump-sum payment based on the value of the projected benefit that would have been earned had the deceased worker continued working until normal retirement age.

- Lump-sum payment (through a group life insurance program) up to one hundred times the expected monthly pension benefit that the deceased employee would have received had that person reached normal retirement age.

- Lump-sum payment that is designed to meet "final" expenses of the deceased worker (burial, funeral expenses, etc.).

For post-retirement death, a pension plan usually gives participants the opportunity to choose among several survivor options (in addition to the qualified joint and survivor option required by ERISA). The plan may also offer survivors a small lump-sum payment for funeral and burial expenses.

It is important to recognize that the various forms of death benefits provided through a pension plan are not necessarily available to all survivors. Some pension plans specifically require that the beneficiary be a surviving spouse or perhaps a surviving child. This requirement could exclude survivors of single employees from qualifying for a death benefit. Other limitations on survivor benefits also exist.

Monthly survivor benefits are taxed as ordinary income (after the retiree recovers the value of any employee contributions that were made). Lump-sum payments also are generally taxed as ordinary income, although they may be eligible for favorable ten-year forward averaging (designed to lower the tax rate on the distribution). The first $5,000 of a lump-sum payment is exempt from federal taxation.

- Group Term Life Insurance: Employer-sponsored group term life insurance plans are a third major source of death benefit protection for employees and their families. For white collar workers, benefits usually are a multiple of a person's annual base salary. In the private sector, the typical range of coverage is between one and two times annual base salary for full-time employees, rounded to the next higher $1,000. In large corporations, this basic level of life insurance coverage usually is non-contributory.

A life insurance plan almost always contains an accidental death and dismemberment provision, which provides additional benefits in case of accidental death. Some employers continue life insurance coverage after retirement at reduced levels, while others terminate coverage when an employee retires.

An employee has the latitude of naming any beneficiary desired (or else the payment is made to the person's estate). As noted previously, pension plans may allow employees less flexibility in designating a beneficiary and, thus, may exclude certain classes of employees altogether from employer-provided death benefit protection. Many employers cover all active employees under their life insurance plans from the date of hire or after a relatively short waiting period. This gives employees of all ages, regardless of marital status, a basic source of death benefit protection.

While survivor distributions from pension plans are taxed as ordinary income, group term life insurance payments are tax free to the designated beneficiary, although subject to tax on the deceased person's gross estate.

- Summary: I have identified three major sources of survivor income that are available in the public and private sectors. Social Security can provide substantial survivor income to individuals, depending upon specific circumstances, or it can provide virtually nothing. In designing survivor benefits for federal employees, Congress should recognize the possible range of death benefits that may be payable under Social Security.

Employer-sponsored pension plans and life insurance plans can provide valuable death benefit protection for employees that supplements basic Social Security benefits. Each plan has advantages and disadvantages which decision makers should understand. Particular attention should be given to the needs of employees in different age groups, the availability of benefits to married, single, young and older employees, the level of benefits offered to survivors under different circumstances, and the tax treatment of pension and life insurance benefits.

Unless care is taken in designing survivor benefits, employees who have the greatest need for this protection may find that they have the least adequate coverage, while other employees, who have a lesser need for death benefit protection, may have the best protection.

A suggested plan of action for designing federal employee survivor income benefits would be to:

(1) Establish objectives that meet the needs of the federal government and federal employees.

(2) Establish Social Security as the basic level of death benefit protection.

(3) Design supplemental benefits, utilizing the best features of pension and group term life insurance plans, and other available sources of survivor income.

Long-Term Disability (LTD) Benefits

The financial impact of permanent and total disability on employees and their families can be devastating if there is no disability income protection. The results can be more severe than the death of an employee, yet protection against income loss arising from disability generally has not been given high priority.

1. Setting Objectives

The fundamental design of LTD benefits, as with the design of survivor benefits, depends upon an employer's objectives for offering this protection to employees. Some of the basic questions that Congress should ask in designing LTD benefits for federal employees follow.

- What level of disability income protection should be provided to employees?

- Would any group of federal employees still be exposed to the risk of substantial income loss by choosing one form of disability income protection over another?

- What definition of long-term disability should be used?

- Who should be eligible for this protection?

- Should there be a waiting period for new employees?

- What is the most efficient and effective means of providing LTD benefits?

- In reviewing current LTD protection for federal employees, what gaps and duplications in benefits exist?

2. Sources of LTD Benefits

In the following discussion, I will be considering three major sources of disability income benefits: Social Security, employer-sponsored pension plans, and self-standing employer-sponsored LTD plans.

- Social Security: Social Security disability benefits are only payable if a covered employee is so severely disabled that the person cannot perform any substantial gainful work and the disability is expected to last at least 12 months or result in death. Furthermore, a person must have been disabled for five full consecutive months in order to begin receiving benefits. And last, disability benefits will be payable only if the person has paid Social Security taxes for a specified number of quarters, which would vary based upon a person's date of birth and date of disability.

  Because of Social Security's stringent eligibility requirements, many disabled employees do not qualify for these benefits. If these eligibility requirements are met, there is no guarantee that Social Security disability benefits will be adequate. Benefit levels depend upon a person's covered earnings, number of family dependents, and to some extent the age when a person becomes disabled. The following table, excerpted from A. Haeworth Robertson's book, The Coming Revolution of Social Security, illustrates the wide variation in levels of Social Security disability benefits by earnings level.

Ratio of Initial Social Security Disability Benefits to Average Earnings Prior to Disability for Illustrative Workers[a]

Earnings Level of Worker[c]	*Replacement Ratio*[b] *When Disability Began at . .*	
	Age 25	*Age 50*
(1)	(2)	(3)
	Single Worker	
Minimum	70%	70%
Average	54	53
Maximum	44	39
Twice Maximum	22	20
	Married Worker with Eligible Family[d]	
Minimum	110%	110%
Average	99	97
Maximum	76	69
Twice Maximum	38	34

[a] Public Law 96-265 (enacted June 9, 1980) made a number of changes in the way benefits are calculated for disabled workers and their families. The disabled workers in this example would not be affected; however, benefits would be reduced somewhat for persons becoming eligible for family disability benefits in the future.

[b] Replacement ratio equals the disability benefits payable in the first year divided by the average of the last three full years of earnings prior to disablement. In each example the worker is assumed to become disabled in July 1979 and to begin receiving benefits in January 1980.

[c] "Minimum" denotes earnings equal to the minimum wage in each year. "Average" means earnings in each year equal to the average wages of all covered employees. "Maximum" and "Twice Maximum" refer to the level of the maximum contribution and benefit base under Social Security.

[d] Family is assumed to consist of worker, spouse, and one or more children.

Source: The Coming Revolution in Social Security, by A. Haeworth Robertson (Reston, Va.: Reston Publishing Co., 1981), p. 234.

Although this table is based upon benefits commencing in January 1980, the relative levels of income replacement are still valid today. Social Security disability benefits can provide almost full replacement of lost income for people in lower-salary brackets and replace very little for those in the upper brackets. The challenge to employers is to design an LTD program that supplements Social Security benefits and provides appropriate income replacement to employees at each salary level.

- Pension Plan Benefits: Employers sometimes choose to provide employees with disability income protection through their pension plans. This can be accomplished in several ways. For example, the disability benefit may be established as a fixed percentage of the person's base compensation as of the date of disability, a percentage of the person's accrued pension benefit, or a percentage of the person's pension benefit projected to normal retirement age.

Disability benefits typically are paid on a monthly basis until the employee (if unrecovered) reaches normal retirement age. At that time, the disabled employee may be reclassified as a retiree. He then might become entitled to a pension benefit based upon compensation at the time of disability and service projected from the date of disability up to normal retirement age. When disability occurs after reaching early retirement age, the disabled employee may begin receiving regular early retirement benefits instead of disability benefits.

Typically, employees must meet a length-of-service requirement under the employer's pension plan to qualify for disability benefits. The service requirement may be 5 years (most commonly found in the public sector), 10 years, and sometimes 15 years or longer. FCSRS currently requires 5 years. This means that employees who do not meet the pension plan's length-of-service requirement would not have any disability income protection unless covered by a separate LTD plan. The most vulnerable employees are young, short-service workers with growing family responsibilities.

All disability benefits are taxed as ordinary income unless a disabled employee becomes eligible for the tax credit for the elderly and disabled.

- Long-Term Disability Income Plan Benefits: Many private employers provide their employees with disability income protection through long-term disability income plans that are independent of employer-sponsored pension plans. These plans may be insured or self-insured.

Generally, coverage is available to all full-time employees as of the date of hire or after a short waiting period. These plans provide disability income protection equal to a percentage of an employee's base salary at the time of disability, usually ranging between 50% and 66 2/3% of salary. Benefits ordinarily commence

3 to 6 months after the onset of disability if other plan requirements have been met. Benefits are offset by Social Security and other sources of disability income.

One of the principal advantages of providing disability income protection through a separate LTD plan is flexibility in meeting employer and employee needs. For example, there is ease in coordinating benefits with Social Security and other sources of disability income without being concerned about meeting IRS integration rules that apply to pension plans. Furthermore, all covered employees can be offered the same level of disability income protection, regardless of length of service with the employer; short-service employees would receive the same level of disability benefits as career employees.

When a separate LTD plan is offered, a well-designed pension plan ordinarily would not offer additional disability benefits. Instead, it might grant disabled employees credited service from the date of disability up to normal retirement age, when LTD plan benefits usually cease. The disabled employee would then be reclassified as a retiree and his pension (under a defined benefit plan) would be based on salary at the time of disability, years of credited service up to the date of disability, and projected service from the onset of disability to normal retirement age.

> The tax treatment of disability income benefits payable from an LTD plan and a pension plan is the same; the entire amount is taxed as ordinary income unless a disabled employee qualifies for the tax credit available to the elderly and disabled.

Summary

The purpose of my presentation today was to discuss the basis of designing death and disability benefits for federal employees. As I stated at the outset,the process of designing these benefits for federal employees should be no different than the process used by other major employers in designing benefits for their employees.

The first step is to set forth specific objectives that meet both employee and employer needs. Then, it is essential that all available sources of death and disability benefits be understood and evaluated carefully. Social Security should be established as the basic level of death and disability income protection; employer-provided death and disability benefits should be designed to supplement Social Security benefits. Flexibility, tax treatment of benefits, and equity across different employee groups are just a few of the factors that should be considered in determining the most appropriate design of supplemental death and disability benefits for federal employees. The key to success will be prudent and thoughtful planning.

COST-OF-LIVING ADJUSTMENTS

by

Dale B. Grant
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UNITED STATES SENATE

July 10, 1984

The protection of purchasing power in retirement has become the subject of increasing attention during the last several years. Inflation is obviously the direct cause of that attention. But there are other demographic, social and economic factors which have enhanced its importance.

- The trend towards earlier retirement lengthening the payout period over which inflation is a factor.
- Continued advances in life expectancy also adding to the length of the payout period.
- The high cost of medical care at the older ages.
- The difficulty of saving for retirement during inflationary periods, and, when savings can be accumulated, the difficulty of investing at rates that will keep up with inflation.

For an employer intent on providing post-retirement income protection, there are two basic issues:

First, setting the benefit objective - deciding in effect, how much protection should be provided. And second, choosing the approach for delivering that benefit objective.

Setting the benefit objective

Defining a policy for post-retirement benefit adjustments involves the same basic considerations that apply in setting the initial benefit level: income adequacy; employee needs and expectations; equity among employees and the consumers who are charged for the cost of benefits; competitive pressures; productivity objectives; and available financial resources.

Adequacy, in the context of post-retirement benefit protection, is related to the adequacy of the benefit level at the point of retirement. If the initial retiree benefit is large in relation to the initial retirement income objective, a certain amount of inflation protection is built in. If, instead, it is below the initial income objective, post-retirement protection becomes even more important.

In evaluating adequacy, it is also important to consider Social Security and the portion of total retirement income it provdes; Social Security is fully indexed to inflation. Thus, an employee who receives one-half of his or her income from Social Security, has 50% of lost purchasing power replaced by Social Security alone. To protect such an employee against 75% of lost purchasing power, plan benefits need only be adjusted by half the rate of inflation; again, because Social Security is fully adjusted. Consider the following example: The inflation rate is 10%.

		After One Year	
	Initial Income	No plan adjustment	Plan adjustment equals 50% of inflation rate
Plan benefit	$ 5,000	$ 5,000	$ 5,250
Social Security	5,000	5,500	5,500
	$10,000	$10,500	$10,750
Lost purchasing power		$ 1,000	$ 1,000
Total post-retirement supplement as a percent of lost purchasing power		50%	75%

Social Security represents a varying proportion of total retirement income. It is often the major source of retirement income for the lower paid. But it represents a very small proportion of total retirement income for the higher paid. That makes it difficult to design a post-retirement adjustment formula for a retirement plan which works equally well at all income levels. It may be said that higher income employees require larger post-retirement supplements from their retirement plan because the full indexing of Social Security does little to replace their lost purchasing power. However, most employers feel an obligation to protect that portion of income that is used for essential expenditures. This implies greater adjustments at lower-income levels.

Finally, a decline in income over the period of retirement does not, by itself, imply declining living standards. There is a question as to whether or not an individual has constant needs during the period of retirement in real dollars. There is a trade-off between declining expenses because of the retiree's increasingly sedentary lifestyle and the increased cost of additional care and medical expenses as the retiree's physical condition deteriorates. The trade-off will vary for individual people. Studies done so far, focusing on expenditures during the period of retirement, are inconclusive. Expenditures are to a large extent, a function of income rather than a function of need.

In practice, to date most employers in the private sector have been adjusting pension benefits after retirement at the rate of 50% to 80% of the rate of inflation, after taking into account the full indexing of Social Security. In the public sector, the range of adjustments is greater. Many pension plans call for an automatic adjustment at some modest level such as 2% or 3% per year. Others - a declining number - fully adjust for increases in the CPI, like Social Security. Still others, the growing majority, adjust on an ad hoc basis ranging from 50% to 100% of the rate of inflation. Few public employers recognize the full indexing of Social Security in setting their plan adjustments.

Finally, some public plans call for an automatic adjustment to benefits based on the excess of investment earnings over some stated rate.

The benefit objective for adjustments after retirement can take several forms.

It can be:

- Related directly to the inflation rate - such as a percentage of the increase in the CPI. This has traditionally been the most common approach to providing supplements, particularly when the ad hoc approach is used.

- A fixed integrated percentage increase per year, such as 3% on the benefit up to $6,000 and 6% of the excess.

  By integrating the benefit increase with a higher adjustment on income above a certain level, purchasing power is protected somewhat more evenly at various income groups. An example of this approach would be to provide adjustments of 3% of the original plan benefit up to $6,000 and 6% over $6,000.

- Catastrophic protection - that is, increasing benefits by the rate of inflation in excess of a specified percentage, such as 3% or 5%.

  Catastrophic protection assumes that the retiree can absorb or may be expected to absorb, some level of inflation through personal savings or reduced expenditures. This is an approach which may be effective for sporadic, short-term high rates of inflation. It is less effective when moderate rates of inflation continue over an extended period.

° A fixed flat percent per year, independent of the actual inflation rate, such as 3%, perhaps with some maximum dollar increase.

A flat percentage increase per year has the advantage of having a known cost for the employer. However, since it is not related to the rate of inflation, it may prove overly generous in periods of low inflation and insufficient in periods of high inflation.

° Under a defined contribution approach, the amount of annual increase that can be purchased with a specified dollar amount.

Approach for delivery of benefit objective

Post-retirement supplements can be provided on an ad hoc basis, through a defined benefit plan, a defined contribution plan or with a combination of these approaches. The approach used is to some extent related to the form or formula for the adjustment and to a lesser extent to the approach used to deliver basic retirement income.

Ad hoc approach

The ad hoc approach is one that leaves open the decision to provide post-retirement supplements. This does not necessarily imply the absence of a policy for making adjustments. Rather, it represents the absence of a formal commitment to benefit increases. Almost all employers in the private sector have chosen to provide for benefit supplements to their employees on an ad hoc basis. The adjustments are customarily related to the inflation rate and made either at specific intervals, such as every two or three years, or after accumulated inflation has reached a certain level, such as 25%. While many pension plans covering public employees call for automatic cost-of-living adjustments at some level, ad hoc adjustments are also common.

Providing retirement supplements on an ad hoc basis has several advantages for the employer:

1] Flexibility

The employer retains control of the amount and timing of the supplement.

2] Predictability of cost

The adjustment can be made after the cost impact is known.

3] Public relations value

The employer gets credit for each adjustment as a benefit increase.

However, if adjustments are made on an ad hoc basis, employees have little security that their retirement income will be protected in the future. Moreover, to the extent that employee expectations are raised, the flexibility of the employer to reduce or eliminate adjustments is limited.

Defined benefit approach

A defined benefit approach - one that provides a stated formula for post-retirement benefit adjustments - provides the surest means of meeting a stated benefit objective. That has some distinct advantages for the employers and employees. It also has some disadvantages. It commits the employer to the cost of benefit increases, the amount of which are to a large extent uncertain.

However, the formula for the adjustment can be defined to limit the uncertainty and financial impact of the increase. The post-retirement adjustment formula could, for example, be 3% per year up to a maximum of $2,000, or 3% on the first $20,000 of benefits. Or, it could be related to the increase in the cost-of-living with a fixed maximum of, say 3%.

If the supplement is defined as a fixed annual rate, costs can be calculated with relative certainty. If the adjustment is related to the rate of inflation, to a limit, the maximum cost can be determined with relative certainty.

If the rate of inflation over a period is such that the guaranteed defined benefit adjustment is not sufficient, further supplements could be provided as needed on an ad hoc basis.

Defined contribution approach

Post-retirement protection could be provided through a defined contribution approach as a part of a basic defined contribution retirement plan or as a separate "post-retirement protection" plan. It could involve financing entirely by the employer, or require a combination of employee and employer dollars. In the public sector, where indexing is widespread, contributory plans are common. Though uncommon in the private sector in the traditional form, savings or thrift plans in which companies' dollars are related to employee contributions are gaining rapid popularity.

At retirement, an employee's accumulated contribution account could be converted into an increasing annuity related to his or her retirement benefits.

Under this approach, the employer's fixed cost commitment is limited to its fixed or matching contribution under the savings plan.

The employee, on the other hand, assumes the risk of an inadequate retirement subsidy from two sources.

First, if inflation is high during the contribution period, the contributions made on early career salaries will have relatively little value in relation to final earnings. Second, if inflation is high during retirement, the annuity will be inadequate.

A savings plan arrangement also has some general shortcomings:

- Additional recordkeeping and administration is required.
- The size of the adjustment the account can provide varies greatly by length of service.
- It cannot take care of employees already retired and can do very little for those close to retirement. Continued ad hoc adjustments are necessary for some time.

If investment return is approximately equal to salary growth over the period of the employee's participation in the savings plan, a 4% total contribution [employee plus employer] will produce an account at retirement which is equal to one times final salary after 25 years. That account will provide a 3% COLA beginning at age 65 on a retirement benefit, exclusive of Social Security, equal to 40% of final salary. After 35 years, the amount in the savings account will provide a 4% COLA.

Combined approach

It is possible to take advantage of the positive features of all the strategies discussed previously in a combined financing strategy.

As an example:

A savings plan approach can be used as the basic mechanism for increases in the long-term future. But, the accounts will produce very little for those retiring during the next 20 years or so. This short-term inadequacy could be filled by a defined benefit guarantee. That is, a defined benefit pension plan could guarantee an annual increase of say 4% per year. If the adjustment supported by the savings plan is less than 4%, the pension plan could make up the difference. After one generation, the savings plan will produce higher adjustments and little or no benefits would be needed from the pension plan.

Finally, if the savings plan or defined benefit guarantee is not sufficient during periods of high inflation, additional supplements could be provided on an ad hoc basis.

Table I

ADVANTAGES and DISADVANTAGES of ALTERNATIVE APPROACHES

	Ad Hoc Adjustments	Defined Benefit Approach	Defined Contribution Approach	Combined Approach
ADVANTAGES	Flexibility is maintained. The employer decides when and if increases will be granted. The employer gets credit for each adjustment	The benefit is defined and assures a basic level of protection	The cost is certain and contained and may, in part, be shared by employees Defined contribution plans are popular among employees because the additional employer contribution is immediately visible in their accounts rather than in the form of a deferred promise.	The cost is contained and shared in part, by employees. A guaranteed benefit is defined and assures a basic level of protection. Defined contribution plans are popular among employees.
DISADVANTAGES	Employees have little security that their retirement income will be protected in the future. The cost of benefits for current employees is shifted to the next generation. Benefit levels need to be reviewed frequently.	If benefits are a function of future salary levels, the cost is uncertain. The employer is committed to a benefit that it may ultimately be unable to afford.	The benefit supportable cannot be defined in advance. The employer will be committed to a contribution which it may ultimately be unable to afford. The need for ad hoc increases will continue until substantive contribution accounts accumulate.	If a function of future salary levels, the cost is uncertain. The program may be complicated and difficult to communicate. With high inflation rates, employees may reject the guaranteed increase as insignificant, or may consider the required contribution too high for the benefit purchased.

THE IMPACT OF VESTING IN CONNECTION WITH A RETIREMENT PROGRAM FOR NEW FEDERAL HIRES

and

EMPLOYEE CONTRIBUTIONS IN CONNECTION WITH A RETIREMENT PROGRAM FOR NEW FEDERAL HIRES

Papers by

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Discussion Topic

THE IMPACT OF VESTING IN CONNECTION WITH A RETIREMENT PROGRAM FOR NEW FEDERAL HIRES

In both public and private retirement systems, vesting and its availability are issues of continuing interest and of some controversy. Simply put, the issue of vesting is a question of whether a participant in a retirement program should be required to meet minimum service requirements (e.g., 10 years) before he or she is entitled to retirement benefits, or rather that person be entitled to those benefits immediately after entering the retirement program. Viewed another way, it is a question of whether longer service or career employees should receive additional benefits (i.e., rewards) at the expense of short service employees.

1. Vesting in General

The two opposing views on vesting relate to the cost of vesting versus the social desirability of generous vesting provisions. A service requirement for vesting in a retirement program enables the longer service participants to receive greater benefits than would otherwise be payable if full and immediate vesting were available. For example, if a plan sponsor had only a fixed amount of money to contribute to a retirement plan each year, the contribution would fund the benefit of fewer employees, or fund benefits to a lesser extent, if liberalzied vesting were provided since employees who do not vest receive no benefits. The greater the turnover rate (i.e., termination of employment) the greater level of benefits that can be provided to long service employees. Various "rules of thumb" indicate that deferred vesting, say 100% after 10 years, can increase the benefits of career employees by 5-15%.

The social desirability of liberal vesting is that full and immediate vesting results indirectly in a type of reciprocity between retirement systems. Regardless of how many different retirement programs an individual participates in throughout his or her career, each separate period of service will be counted in determining that person's ultimate retirement benefit. The social benefit to be gained by this is that there may be less reliance on federal programs such as social security or welfare. However, this "benefit" is difficult, if not impossible, to quantify.

2. Types or Degrees of Vesting

Vesting requirements can range from the extreme of full and immediate vesting at plan entry, to vesting only upon reaching retirement age. The latter extreme is virtually non-existent in the private sector since ERISA was passed in 1974. The trend since then has been for shorter and improved vesting requirements. For purposes of this discussion, the extreme end of vesting requirements will be 10 years for 100% vested status, which is a common period in retirement programs. Once a period (i.e., 10 years) is determined for full or 100% vesting there are two choices for vesting between plan entry date and full vesting, "cliff vesting" or "graded vesting". Cliff vesting means that a participant has no rights until the vesting service requirement is met, and 100% thereafter. Graded vesting, which can be structured a number of ways, eliminates the "all or nothing" problem which cliff vesting creates, by providing a participant with increments of partial vesting for year(s) before full vesting. Again, in deciding between cliff vesting or graded vesting, one must balance the issue of greater benefits (and reduced costs of vesting) and equity (or social desirability).

3. Defined Benefit Plan vs. Defined Contribution Plan, or Combination

Theoretically, the issue of vesting should be independent from the type of plan involved. However, in the private sector, vesting requirements in defined contribution plans tend to be more liberal than for defined benefit plans.

One reason for this may be that defined benefit plans tend to be viewed as more of *post-retirement age income benefit plans*. Defined contribution plans are sometimes viewed as on-going savings or accumulation programs, providing *lump sum* benefits at termination, whether or not retirement age has been reached. Because of this, the forfeiture of non-vested benefits in a defined contribution plan may appear more as dollars *taken away* by the plan sponsor, than as benefits *not yet earned*, as under a defined benefit plan.

4. Summary

In designing a retirement program for new federal hires, it is the author's opinion that the type of plan (i.e., defined benefit versus defined contribution) should not be a significant factor. The issue to analyze here is the degree to which greater benefits should be provided at the expense of some inequity.

In connection with this decision, the following is a list of some major pros and cons with respect to full and immediate vesting.

Pros

1. Full and immediate vesting enhances the mobility of the work force. This may provide added flexibility to the government's task of meeting manpower requirements.

2. An employee's decision to join or remain in federal service might be governed more by the job requirements than by the benefits.

3. Full and immediate vesting may be more equitable to plan participants.

4. Full and immediate vesting would eliminate the current "hang-on" syndrome of federal employees nearing full vesting service.

Cons

1. Plan benefits would tend to be lower and, therefore, less attractive to new hires.

2. The lower the benefits the greater the disparity in benefits between new hires and current workers.

3. The incentive to be a career federal service employee would be lessened. This may be a pro for many job classifications and a con for certain key positions, where a large direct compensation difference exists between the private and federal sectors.

4. There would be added administrative burdens and costs as more people would be entitled to benefits.

Discussion Topic

EMPLOYEE CONTRIBUTIONS IN CONNECTION WITH A RETIREMENT PROGRAM FOR NEW FEDERAL HIRES

Attached is an excerpt on employee contributions from Thomas P. Bleakney's book, "Retirement Systems for Public Employees". Much of the material written by Mr. Bleankey is not only relevant to this discussion topic, but also provides an excellent background explaining why public systems are often contributory. To supplement and update Mr. Bleakney's comments, I have developed the following thoughts.

1. In a sense, an employee contributory plan is a forced savings type of program. This obviously results in greater retirement income protection, particularly if the refund of employee contributions for terminations is at a lower interest rate than earned by the fund (i.e., interest gains may go toward increasing benefits for remaining employees).

2. If an employee is forced to contribute to the new federal retirement program after paying taxes on such contributions, he or she will be at a disadvantage when compared with employees in non-contributory plans, who can contribute to IRAs or other deferred compensation plans (i.e., 401(k)) from before-tax dollars.

3. Since new federal hires will already be substantially contributing to Social Security (i.e., nearly 7% of pay), requiring additional contributions to the new federal program will result in lower take-home pay for a new worker at the same GS level as a current federal worker.

4. There are added administrative burdens and costs to any contributory system.

5. The issue of employee contributions should not be impacted by the type of plan (e.g., defined benefit or defined contribution).

From "Retirement Systems for Public Employees"

(By Thomas P. Bleakney)

EMPLOYEE CONTRIBUTIONS

Only about one employee out of every four covered by a private retirement plan in the United States is required to help pay for the plan by means of employee contributions.[8] This pattern is markedly different from the general rule among public employees. In fact, over 90 percent of the members of public employee retirement systems are required to make contributions.[9] This difference in practice displays a consistent adherence by most public employee retirement systems[10] to the philosophy that once prevailed in all plans—joint financing of retirement benefits.

Advantages of Contributory Systems. An early expression of this philosophy was given by the Commission on Pensions of New York City in 1918, as their grounds for recommending the adoption of contributory systems for that city:

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[6] See p. 68.

[7] See p. 49.

[8] U.S. Department of Labor: Bureau of Labor Statistics, *Labor Mobility and Private Pension Plans*, Bulletin No. 1407, 1964.

[9] Of 264 systems providing usable data in response to two surveys of the Social Security Administration in the United States and to the author's survey of Canadian systems, 251 systems were contributory. See Social Security Administration Research Reports No. 15 and 23: *State and Local Government Retirement Systems, 1965* and *Retirement Systems for Employees of State and Local Governments, 1966*.

[10] A notable exception is found in the state of New York. Under a 1960 amendment to the governing laws of the New York Public Employees' Retirement System, the state and all participating political subdivisions which have so elected make additional contributions to replace all or a portion of their employees' contributions. This feature of the system, which is referred to in the law as "pensions-for-increased-take-home-pay," has converted the New York system from a fully contributory to a noncontributory system for the majority of its members. In similar fashion, the New York State Teachers' Retirement System and other systems in New York have become largely noncontributory.

> A system in which both parties contribute is proposed because . . . of the sense of mutual responsibility thereby fostered for the provision of benefits which will be equitable and advantageous to both parties. . . . Through the responsibilities thereby developed for the provision and retention of benefits equitable to both parties, there would be a natural check on overliberal interpretation and legalized liberalization of the provisions which would make the system unduly costly to either party.[11]

A restatement of this philosophy with a slightly different twist and the advantage of 50 additional years of experience is found in succinct comments made by the Legislative Retirement Study Commission in its report to the 1971 legislative session of the state of Minnesota. Among several other guidelines for the legislature, the Commission includes the following statement of principle:

> Governmental employer support of normal level pension costs should not exceed equal matching of the employee's contribution to his pension, except as to certain law enforcement and safety employees. To provide a greater share of the benefits at governmental expense tempts employees to strive for extra benefits and marginal benefits because the cost to the employee is small. Pensions should not become "hidden extra salary."[12]

These statements embrace the concept that the costs of benefit improvements should be shared between the parties. This in turn necessitates cost determinations which will provide a basis for this sharing. Within this framework, a contributory system can provide retirement benefits in an environment of responsible management where the costs are known and shared.[13] It will be noted that this concept is not always conspicuously present. It will also be noted, incidentally, that the goals of responsible management can be met in a noncontributory system if the costs (after having been appropriately determined and disclosed) are recognized by both the employer and employees as alternatives to similar expenditures in direct payroll. This approach involves pricing pension costs in cents per hour, an idea that is widely accepted in collective bargaining in the private sector.

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[11] Commission on Pensions, *Report on the Pension Funds of the City of New York* (New York, 1918), pp. 15–16.

[12] Legislative Retirement Study Commission, *Report to the 1971 Legislative Session of the State of Minnesota* (St. Paul, 1971), p. 12.

[13] The information needed for the costs to be known will be discussed in Chapter 5.

From the employee's viewpoint, a strong argument favoring his making contributions is the leverage it gives him in enforcing his rights to benefits and in insisting on adequate employer contributions. The employee who makes his contribution has a moral, if not a legal, right to expect the employer to do likewise. For the same reason, the employee may have stronger cause to believe that the retirement program will be maintained than if he were not making contributions. This concept was stated by President Franklin D. Roosevelt in a reference to the United States social security program:

> We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program.[14]

Disadvantages of Contributory Systems. Probably the greatest of the disadvantages of contributory systems in the United States is that contributions made by the employee must be paid from after-tax dollars. The employee must include contributions deducted from his salary in his taxable income, even though they are locked into the fund and he does not have use of them while he remains at work. This disadvantage is offset to a slight extent after retirement, when a portion of his pension is tax free. However, this offset is of no value to many retired employees, since it is common for a retired employee's personal exemptions and deductions to exceed his taxable income. The importance of these tax considerations in plan design is difficult to measure. It is interesting to note, however, that in Canada, where salary deductions for contributions to registered pension plans are tax-deductible, contributory plans are much more common, covering over 60 percent of employees under retirement plans in the private sector.[15]

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[14] Arthur M. Schlesinger, Jr., *The Coming of the New Deal* (Boston: 1957), p. 308.

Contributory plans have other drawbacks besides adverse tax consequences. A contributory plan is more difficult and expensive to administer. Employee contributions are inconsistent with the growing recognition of pensions as deferred compensation, rather than as joint savings programs. A contributory plan may inhibit good employee relations, particularly among those who are many years from retirement. For the younger employee, the required contribution may be looked upon as an onerous burden to be met at a time in his career when he is least able to afford it. Finally, if a given level of employer and employee contributions is set aside under a contributory plan, that same level, contributed solely by the employer, will generally produce greater benefits. This is partially due to savings in expense, but in larger part is due to the avoidance of refunds to employees upon termination of service prior to retirement.[16]

Level of Contributions. Under a contributory system, the employee normally contributes a stated portion of his monthly salary—typically, 4 to 6 percent. This contribution is a form of savings deposit, since eventually it will be returned in the form of retirement, death, or disability benefits, or refunded upon termination of employment. In this respect, public employee retirement systems differ from social security where the contributions are, in effect, taxes levied to provide funds to pay benefits to current beneficiaries. The employee's obligation is usually expressed as a percentage of all, or a part of, his earnings. A fixed-dollar contribution is seldom used. This reflects the correlation between contributions and benefits, since the latter are also nearly always related to salary. The actual amount an employee contributes varies considerably among the different public employee retirement systems. This variance is due not only to differences in the contribution rates themselves, but also to differences in the salary bases to which the rates are applied.

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[15] Statistics Canada, *Pension Plans in Canada, 1970* (Ottawa, 1972).

[16] This cost disadvantage of contributory plans is diminished or eliminated to the extent that employees forfeit vested benefits upon termination of employment in order to collect their accumulated contributions. See p. 69.

The majority of public employee systems express the employee contribution in terms of a percentage, or a range of percentages, of the member's total basic earnings, exclusive of overtime pay or any other special allowances. For the purpose of administering payrolls, this method is probably the most economical and has all the other advantages of simplicity. Nevertheless, a significant number of systems require contributions on earnings up to a specified amount only. Common limits are \$3,600, \$4,800, \$6,000, and \$7,500. The lowest two of these limits reflect the United States social security wage bases during different periods. A variation on this pattern occurs in many systems, where contributions are made at a specified rate on annual earnings up to similar dollar limits, and then at a higher rate on all earnings in excess of such limits.

Although typical employee contribution rates might be 4 to 6 percent of earnings, actual contribution rates vary over a much wider range. In a number of systems the employee contribution rates vary by a member's sex, the age at which he enters the plan, and sometimes the type of work he does. The percentages of salary contributed by members of a system of this type are given in Table 1. The reasons for the variation in contributions by age and sex in this table are

TABLE 1
Employee Contribution Rates, New Jersey Public Employees' Retirement System

Age at Entry	*Percentage of Salary*	
	Male	*Female*
25	4.91	5.51
30	5.19	5.85
35	5.59	6.30
40	6.04	6.81
45	6.55	7.39
50	7.12	8.02
55	7.84	8.83

related to the benefits provided under the system.[17] In most of the systems with this type of contribution schedule, member contributions, accumulated to retirement, are designed to provide a specified portion (often one half) of the total retirement benefit.

Interest Credited on Employee Contributions. In the type of system just mentioned, where there is a direct relationship between the accumulated employee contributions and the retirement benefit, vital issues are involved in determining the rate of crediting interest on the accumulated contributions and the rate basis used for converting these accumulated contributions into annuities at retirement.[18] Extended litigation involving these issues has occurred in some systems, an indication of the importance of proper treatment of employee contributions in public employee retirement systems.

An important consideration in determining the rate of interest to be credited in accumulating employee contributions is whether employee contributions are to be viewed as savings of the employee or as part of his price for the retirement benefit. The employee who terminates before retirement has made his contributions as a form of forced savings. While the same might be said for the employee who remains in employment until he retires, his savings then serve the primary purpose of providing a contribution towards the total cost of his retirement benefit.

It is significant, in this regard, that employee contributions in public employee retirement systems are nearly always a condition of employment: All new employees must join the system and make the required contributions when they become eligible. If employee contributions are regarded as a form of forced savings, an employee might well contend in equity that his contributions should be credited with interest at a rate comparable to that which they would receive in an equally safe investment of his own choosing.

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[17] See p. 39.

[18] See p. 41 regarding annuity conversion rates.

In practice, a wide spectrum of philosophies appear to exist in the crediting of interest on employee contributions. At one extreme are systems where an employee is not only paid no interest but forfeits all of his contributions if he should terminate early in his career. This type of provision, where it exists, is usually found in a system covering policemen or firefighters.

Not quite so adverse to the employee, but confiscatory nonetheless, are systems which credit no interest on the contributions of terminating employees. There are also systems which pay only a nominal rate of interest, such as 2 or 3 percent, on the accumulated contributions. In these systems, the employee who terminates is, in effect, making a contribution towards the pension of his fellow workers, in the amount of the foregone additional interest on his contributions.

Many systems, particularly the larger ones, credit interest on the accumulated contributions of each member at a rate approximately equal to the earnings rate of the system as a whole. This technique puts the employee in an equitable position with the employer as to the earnings on the funds contributed by the respective parties. In a well-managed system, the interest so credited will compare favorably with that provided by other savings media, such as banks, savings bonds, and life insurance.

STATEMENT OF

H. GRAY HUTCHISON
HUTCHISON AND ASSOCIATES, INC.

COMMENTS ON "PROGRAM OPTIONS" FORUM
Held July 10, 1984

I am Gray Hutchison, Chairman of the Board of Hutchison and Associates, Inc. of Raleigh, North Carolina. We are a full-service actuarial-employee benefit consultant firm serving the Southeastern region. Our clientel is made up of private sector employers and governmental employers in our region. We are therefore experienced in the design, funding, and political problems that are involved in the establishment and operation of governmental plans. We are also equally aware of what private employers working side by side with governmental employees are providing.

This series of forums, of which this is the fifth and last, has been extremely helpful in bringing out the factors that the Congress should consider as they deliberate on the future of Federal Civil Service and the form that the retirement program for that group of employees should take. The issue is clear: Are we to make the mistakes of the past? Or are we to go forward in new and imaginative ways to solve the problem of Civil Service retirement? A wide range of views has been expressed at these forums ranging from those with vested interests who argue for retaining the status quo to those who see a new approach that by design would avoid the pitfalls of the past.

The first step to take in arriving at a solution is to identify the problem in all of its details. Even among those with widely divergent views on the solution to be adopted, there appears to be a common denominator agreement that the Federal Civil Service program as it has existed cannot go on. For this reason, Congress passed legislation eliminating eligibility for future employees in such system and these forums have been addressing the question of what should replace the old system. Without arguing figures and details (everybody can find fault with any set of figures presented by simply changing the assumptions on which an alternate set of figures have been prepared), let's very briefly look at what has taken place with the Federal Civil Service program as it has existed and why, actuarially, problems have occurred. With this as a base, we can then look at a possible solution that will avoid these pitfalls of the past.

Under the Employee Retirement Income Security Act of 1974, which Congress passed to assure private sector employees that their retirement plans would be fairly and equitably administered and properly funded, there is a requirement that all normal costs must be paid currently and that unfunded accrued liabilities must be amortized by new plans over a period not to exceed thirty years. It is reasonable to assume, in evaluating the Federal Civil Service program that it should be evaluated on the same standard that Congress felt should be required of private sector employers. If we accept this premise as a fair and equitable basis for comparing and evaluating retirement plans, we find that the Federal Civil Service program has in excess of $500,000,000,000 of unfunded liabilities which if amortized over a thirty-year period would require approximately 57% of current payroll. Instead, Congress is paying a hypothetical interest on a much lower unfunded accrued liability which does not comtemplate any future inflation or wage increases. Under this same ERISA approach, the normal cost of the Federal Civil Service plan would be 36%. Of this, the employees now contributing 7%

and the Federal government is matching it with another 7% which is obviously inadequate. The actual amount contributed should be 29% or some four times what the Federal government is contributing. When you add these two items together, you arrive at a total of something like 86% of payroll as the cost of the Federal Civil Service program if it were administered under the standards of soundness established by Congress for private sector employers.

The magnitude of the foregoing items in themselves indicate that you have a problem of major proportions. The next question that arises is why has this taken place. The design of the program has much to do with this:

1. Most private sector plans use a five-year average salary for determining benefits, whereas the Civil Service determines its benefits on a three-year average salary. This could make a difference of from 4% to 9% in cost of the program (depending upon the rate of inflation assumed).

2. Full cost of living adjustment for retirees is offered to Federal Civil Service employees whereas most private sector plans cannot afford this benefit. Just reducing the cost of living adjustment (assuming retirement at age 55 and depending upon the rate of inflation assumed) to one-half would lower the cost of the Federal Civil Service program from 5 to 20%.

3. Civil Service employees take early retirement at 55 and shortly thereafter (which is the maximum point of return to them on service for the government) with unreduced benefits whereas in the private sector actuarially reduced benefits are paid at early retirement. (For this reason, in most plans, an employee cannot afford the luxury of early retirement). Reasonable early retirement reduction factor would reduce the cost of Civil Service from 25 to 50% depending upon whether the age of retirement is age 60 or age 55.

4. A lowering of the benefit formula to bring it more in line with private sector benefits would lower the cost of the program from 7 to 21% depending upon the service years at retirement.

5. Combining all of the factors involved, total cost of retirement could be reduced by 68% for retirement set for 55 to 47% for retirements at 60, which is the period of time in which most Federal employees retire (over 50% retire before age 60).

In short, the foregoing figures indicate where benefits are out of line with the private sector and how their costs, after they have been cranked through the actuarial machine to predict their future impact, have created the problem that has existed in Federal Civil Service, and the system, under present funding practices of the Congress, will continue to fight a losing battle and at best barely hold its own but not gain on the problem. Any new system that we set up is going to have to recognize these problems and avoid the pitfalls that have gotten us into trouble in the past.

Let's assume that the goal for establishing the new Federal Civil Service retirement system--another point on which all parties regardless of other divergent views appear to agree--would be to provide (1) adequate retirement benefits, (2) in a fair and equitable manner comparing the government with the private sector, and (3) on a cost-affordable basis to the taxpayer of the country who is really, in the ultimate sense, the employer of the Federal Civil Service employees.

In looking for a solution, I think we need to recognize that one of the underlying problems that has created the problems in the old system has been the defined benefit approach. It is an approach in which very small and apparently innoculous changes can build up tremendous liabilities. This is indicated by some of the foregoing figures indicating savings that can be affected by what appears to be very minor changes. This makes it very difficult for Congress to evaluate the true cost effect of changes in the system that are proposed to it. The second factor to consider is the nature of the Government employee, who is both an employee of the Government and an employer of the Government (in his role as a taxpayer). In this latter role he does not hesitate to go to his representatives in the legislative body, which at the Federal level is Congress, and ask for more and more benefits which puts considerable pressure upon Congress, in the absence of definitive cost figures evaluating the proposals, to resist such requests. For this reason, any plan that is designed should, if at all possible, be one where all the costs are up front and seen, are easy to evaluate, both by Congress and by the taxpayers, and thus lend themselves to maintaing cost affordability on a short and long range basis. For these reasons, a defined contribution plan would better meet the needs of a new Federal Civil Service program than a defined benefit plan.

A suggested replacement program might be as follows:

1. Set up a 401(k) type arrangement whereby the employee would continue to contribute 7% but on a pre-tax basis and the government would match it with 7%.

2. Give the employee an option in 25% increments of choosing betweeen four to five funds that are managed by private managers. These funds would probably include the following: (a) A guaranteed insurance investment contract; (b) a fund made up entirely of government securities but purchased on the open market; (c) a fund made up of corporate bond and fixed obligations; (d) a fund made up of corporate stock and equity investments; (e) a money market fund.

3. Each employee would have an individual account furnished statements at least quarterly showing the progress of this fund in each of these funds he had selected.

4. Death and disability benefits would be provided outside of the plan by third party insurers (I would recommend against self-insuring since we have had problems with the government's operation of NSLI and other government insurance programs and also in the government's administration of disability programs on a self-insured basis under Social Security and other programs).

5. Some of the participants in these forums have proposed a floor pension to guarantee a minimum income for life. If so, in my opinion, it should be extremely low; otherwise, if it were designed along the Civil Service lines we would be back to the same problems that we now have in the old Civil Service system.

How would the foregoing program measure up on the standards for establishment of a future Civil Service system:

1. Adequacy - First, new Civil Service employees, as in the private sector, should be relatively young. A defined contribution plan at the 14% of pay level would, together with Social Security, provide for most of these, in excess of 100% of pay at retirement. This is considered to be a worthy and adequate retirement goal by various studies that have been made both by the government and the private sector. For older employees, who enter government service, they should have, under the ERISA rules, vested benefits with their private employers which, coupled with the ongoing future service benefit of a defined contribution plan with the Federal government would provide their total retirement at 65.

2. Fairness and Equity - The benefits would compare favorably with what is being provided in the private sector by major employers on a cost basis. The 7% from the government plus the employee cost for Social Security would bring retirement costs in line with the retirement benefits of most major employers in the private sector.

3. Cost Affordable - With a definite percentage of payroll costs, Congress can measure, together with cash wages and values put on vacations, sick leave, and other employer-provided benefits, a total cost of employing an employee and the federal payroll costs can be better managed on a cost effective basis. There would be no hidden costs sneaking up on the taxpayer. It can also be better measured against the private sector, without the smokescreens being raised on credibility of assumptions, etc., to disparage comparisons.

4. Other Benefits - Such an approach, particularly with a choice of investments in the private sector, should make the employee more aware of the free enterprise system under which we presumably operate and which they in government are employed to serve. They would have a greater interest in seeing that the economy prospers and they in turn prosper through their investments in the economy. It would create a healthier attitude with government employees towards the function they have of serving the people who are the taxpayers and the private employers of the majority of the employees in the country.

In short, I feel that the above approach, with refinements, would provide us with an adequate, a fair and equitable, and finally, a cost affordable retirement system.

Comments on Statement by Gray Hutchinson for the Record of the July 10, 1984 Senate Governmental Affairs Committee Policy Forum on Civil Service Retirement

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Date: August 21, 1984

COMMENTS ON STATEMENT BY GRAY HUTCHINSON

Mr. Gray Hutchinson of Hutchinson and Associates did not attend the July 10, 1984 Policy Forum on Civil Service Retirement (CSR), but he did submit comments for the record which appear elsewhere in this Committee Print. Since his views were not available for discussion at the forum, I am submitting these written comments on Mr. Hutchinson's statement.

Mr. Hutchinson refers to the existing CSR system as the product of "mistakes of the past" and "pitfalls of the past." He then proceeds to compare CSR to private-sector pension plans to support these statements. I believe that an objective review of pension policies in the federal and private sectors do not lead to his negative conclusions about the existing CSR system. I will discuss several of the specific points he raises below.

First, Mr. Hutchinson misunderstands the policy context within which the policy forums were held when he states that "Congress passed legislation eliminating eligibility for future employees in such system" because there was "common . . . agreement that the Federal Civil Service program as it has existed cannot go on." This statement is completely false. First, Congress has not denied new hires coverage under the current CSR system; it has continued this coverage while considering possible designs for a new plan to supplement Social Security. Second, the action to extend Social Security coverage to new hires was taken to help improve the financial balance in the Social Security trust fund, not because of any dissatisfaction with CSR. Third, when Social Security coverage was extended to new federal and postal employees, both the Commission that initiated the proposal and numerous Congressional leaders stated that it was their intent that a new supplemental retirement plan retain the key features of the current CSR system.

In beginning his comparison of CSR with private plans, Mr. Hutchinson states that: "It is reasonable to assume, in evaluating the Federal Civil Service program that it should be evaluated on the same standard that Congress felt should be required of private sector employees." However, it is not reasonable to assume that. Congress could have applied ERISA standards to CSR but did not choose to do so, and for a very good reason. The main impetus behind ERISA was to protect individual employees from grossly unfair circumstances in which they found themselves under certain private pension plans due to plan practices regarding vesting and breaks in service and the inadequate financial protection afforded by plan assets. Congress applied the standards of ERISA to private plans in order to prevent these and other problems from arising for future retirees. Such concerns have not arisen regarding federal employee retirement.

Mr. Hutchinson then leaps from ERISA applicability to a claim that, like private plans, CSR should amortize its unfunded liability, in which case the system's cost as a percent of payroll would be quite high. However, there is no demonstrable need to amortize this liability. The federal government is not going out of business and, therefore, can afford to fund pension promises on a current basis. Advance funding is needed for private plans since thousands of private firms do go out of business each year. The only concern one should have about CSR's unfunded liability is whether the future stream of revenue designated to cover this liability as it comes due will be adequate. Mr. Hutchinson does not address this question, but I feel that future revenue will be adequate based on the best projections one can now make about the system's operations.

Mr. Hutchison then makes several specific comparisons between CSR and private pension plans:

- He correctly points out that a 5-year salary average is more commonly used in private benefit formulas than is the 3-year average used by CSR. However, the Wyatt Company's survey of the Fortune Top 50 shows that the largest firms are about evenly split between high-5 and high-3.

- Mr. Hutchinson also accurately attributes to CSR's full COLA a good part of the cost differential between CSR and private plans. However, Mr. Hutchinson asserts that the private sector "cannot afford" full COLAs. Some firms clearly can afford them; they simply have not chosen to use their plan funds in this way. It is important that readers understand why private plans have not offered full COLAs. First, Social Security, which is indexed, accounts for most of the retirement income of lower-paid workers. Second, supplemental retirement plans offer an additional layer of financial protection in the private sector that is not available to federal workers. Third, wage replacement rates from all benefits at retirement are often much higher for private employees than the 56 percent available to the 30-year worker under CSR. Fourth, private firms place more money into other types of financial protection such as health and life insurance than does the federal government. Finally, hyperinflation does pose an unacceptable short-term risk to an individual private plan, but it is not a risk to the federal government unless prolonged and accompanied by economic recession.

- Mr. Hutchinson urges that CSR benefits at the earlier retirement ages should be reduced as they are in private sector plans. It is correct that most private plans apply some reduction factor to benefits drawn at age 55, although only a minority apply a full actuarial reduction. However, Mr. Hutchinson and other critics always fail to note a closely related factor that the recent GAO review of private plan practices reveals. That is, a good many private plans are more generous than CSR in their service requirements for age-55 retirement. The typical private plan offering retirement at age 55 generally permits retirement with far fewer than 30 years of service. Thus, early retirement benefit levels are more generous under CSR than under the typical private sector plan, but early retirement eligibility rules are less generous. Incidentally, Mr. Hutchinson claims that over half of federal retirees retire before age 60. Based on data for FY 1982 that exclude those forced to retire due to disability or to mandatory retirement provisions, only 37 percent of new retirees were younger than age 60. The average retirement age was 61.0.

- Mr. Hutchinson advocates reducing CSR benefit levels generally to bring them "more in line with private sector benefits." A review of the Wyatt survey of the Fortune Top 50 plans shows that CSR is more generous than those plans in some cases but less generous in others. However, if benefits from capital accumulation plans were accounted for, which Mr. Hutchinson never mentions, the retirement plans of the top 50 firms would almost always offer a better deal than CSR at the time of retirement.

Despite Mr. Hutchinson's own very imcomplete and misleading comparison of CSR with private plans, he claims that other people are raising "smokescreens . . . to disparage comparisons" of costs in the two sectors. Actually, the Hutchison statement offers the perfect example of why it is crucial for Congress to have very careful and well-done comparisons of the two sectors. A hasty, poorly prepared comparison is of no use to policymakers who are charged with designing a new federal pension policy that will be both adequate and fair.

The Prudential Asset Management Company, Inc.
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August 2, 1984

Jamie Cowen
Special Counsel
Subcommittee on Civil Service,
Post Office and General Services
SH #601
Washington, DC 20510

Dear Mr. Cowen:

At the July 10, 1984 Federal Pension Policy Forum you expressed interest in the extent to which employees across all income levels participate in an employer sponsored savings and investment plan. I am pleased to furnish you with the following information concerning Prudential's savings plan for its employees. The plan is intended to meet the requirements for a qualified profit-sharing plan under Internal Revenue Code section 401(a). A copy of the booklet describing the plan is attached.

Eligible participants are employees with at least 12 months service. The plan requires that an employee contribute 3% of salary in order to participate. The Company matches 100% of that contribution. In addition, participants may contribute another 10% of their pay to the plan. The participant contributions are not tax deductible. Prudential's contributions are tax deferred compensation for the participants.

The plan enjoys an 85% participation rate among eligible employees. Moreover, contribution rates are approximately the same at all compensation levels. A full one-third of our participants at all compensation levels use the plan to save 3% of their compensation. Another one-third contribute the maximum of 13% of their compensation. The remaining participants at all compensation levels save between 4 and 12% of their compensation. The average employee saves between 7 and 9% of his compensation. The plan data, by salary brackets, follows.

Participation rate --	85%
(a) participants who earn less than $15,000 --	74%
(b) participants who earn between $15-20,000 --	87%
(c) participants who earn between $20-30,000 --	92%
(d) participants who earn between $30-50,000 --	96%
(e) participants who earn over $50,000 --	98%

Average participant contribution rate --	7.7%
(a) participants who earn less than $15,000 --	7.0%
(b) participants who earn between $15-20,000 --	7.8%
(c) participants who earn between $20-30,000 --	7.9%
(d) participants who earn between $30-50,000 --	8.4%
(e) participants who earn over $50,000 --	9.1%

A number of persons at the forums expressed concerns about the possible adverse results of giving employees choices among investment accounts for their plan balances. Page 4 of the booklet describes the investment accounts. The "VCA-6" and "VCA-IF" accounts are invested primarily in common stocks. The Fixed Dollar Account guarantees the principal of an employee's plan balance placed in that account, that is, no adjustments for market value are made upon an employee's withdrawal of funds or transfer of funds from this account. Also, the Fixed Dollar Account guarantees the interest rate to be credited during each calendar year. The interest rate credited to this account for 1984 is 11.50%; for 1983 it was 11.25%. The following is a distribution of current contributions among accounts for the 1973 calendar year to the latest available date. Note that after 1974 there was a shift away from the common stock accounts toward the Fixed Dollar Account, and that after 1978 the ratio of current contributions to the Fixed Dollar Account has remained very stable at 86-87%.

PRUDENTIAL INVESTMENT PLAN
EMPLOYEE (INCLUDES MAKE-UPS) AND EMPLOYER CONTRIBUTIONS
(in millions)

	Fixed Dollar Account		VCA-IF Account		VCA-6 Account		Total
	$	%	$	%	$	%	$
1984 (thru March)	25.9	87	1.3	4	2.7	9	29.9
1983	100.2	87	4.8	4	10.0	9	115.0
1982	91.7	86	4.9	5	10.2	9	106.8
1981	81.2	86	4.5	5	8.9	9	94.6
1980	75.8	87	4.0	5	7.7	8	87.5
1979	75.2	86	4.3	5	8.1	9	87.6
1978	63.5	81	4.9	6	9.9	13	78.3
1977	52.8	75	5.6	8	12.0	17	70.4
1976	42.9	68	6.2	10	13.8	22	62.9
1975	30.2	56	7.2	14	16.3	30	53.7
1974	22.4	45	8.4	17	18.8	38	49.6
1973	12.6	37	6.5	19	15.1	44	34.2

I hope this information will be of use to your Committee.

Sincerely,

James M. McGrath

James M. McGrath
Director, Group Pension Research

cc: D. Salisbury
J. Swenson